# REPORT ON COMPANY LAW

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Chairman
Expert Committee on Company Law

New Delhi, the 31st May, 2005

Dear Mr. Minister,

I have the privilege and honour to present the report of the Expert Committee to advise the Government on the new Company Law, set up by the Ministry of Company Affairs vide Order dated 2nd December, 2004.

The Committee had the benefit of participation by several experts in various disciplines. It has tried to take a comprehensive view in developing a perspective on changes necessary in the Companies Act, 1956 in context of the present economic and business environment. Nevertheless, corporate law is a vast subject and we expect that while the report of this Committee would provide useful inputs for its revision, it may still not be the last word on various issues. However, our effort has also been aimed at making India globally competitive in attracting investments from abroad, by suggesting systems in the Indian corporate environment which are transparent, simple and globally acceptable.

I thank you for providing me an opportunity for working with a wonderful group of dedicated people in presenting our perspective on complex corporate law issues.

Yours sincerely,

Dr. Jamshed J. Irani

The Honourable
Shri Prem Chand Gupta,
Minister for Company Affairs,
New Delhi.

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**Executive Summary**



## Chapter I : Background

1. The Companies Act 1956 was enacted on the recommendations of the Bhaba Committee set up in 1950 with the object to consolidate the existing corporate laws and to provide a new basis for corporate operation in independent India. With enactment of this legislation in 1956, the Companies Act 1913 was repealed.

2. The Companies Act, 1956, has since provided the legal framework for corporate entities in India. The need for streamlining this Act was felt from time to time as the corporate sector grew in pace with the Indian economy, with as many as 24 amendments taking place since 1956. Major amendments to the Act were made through Companies (Amendment) Act, 1988 after considering the recommendations of the Sachar Committee, and then again in 1998, 2000 and finally in 2002 through the Companies (Second Amendment) Act 2002, consequent to the report of the Eradi Committee.

3. Many countries faced with the task of economic restructuring in response to the realities of a changing economic environment, have undertaken comprehensive revisions of their respective corporate laws. UK Companies Act was revised during the

1980s. Subsequently, many countries whose legal systems were derived from UK, such as Australia, New Zealand, Canada etc also undertook reviews of their corporate laws and brought about several comprehensive reforms. It is widely accepted that reform and updation of the basic legal framework for corporate entities is essential to enable sustainable economic reform.

4. After a hesitant beginning in the 1980s, India took up its economic reforms programme in the 1990s. Equally, a need was felt for a comprehensive review of the Companies Act, 1956. Unsuccessful attempts were made in 1993 and 1997 to replace the present Act with a new law. Companies (Amendment) Bill, 2003; containing important provisions relating to corporate governance was also introduced, the consideration of which has been held back in anticipation of the comprehensive review of the Company Law. While piecemeal reform continued through amendments, it has not yet been possible to bring about comprehensive, new legislation to replace the existing Act.

5. In the current national and international context, there is a requirement for simplifying corporate laws so that they are amenable to clear interpretation and provide a framework that would facilitate faster economic growth. It is also increasingly being recognized that the framework for regulation of corporate entities has to be in tune with the emerging economic scenario, encourage good corporate governance and enable protection of the interests of the investors and other stakeholders. In the competitive and technology driven business environment, while corporates require greater autonomy of operation and opportunity for self-regulation with optimum compliance costs, there is a need to bring about transparency through better disclosures and greater responsibility on the part of corporate owners and managements for improved compliance.

6. It is appreciated that the Government has taken up this fresh exercise for a comprehensive revision of the Companies Act 1956 on the basis of a broad based consultative exercise. As a the first step in this consultative process, a Concept Paper on Company Law drawn up in the legislative format was exposed for viewing on the electronic media so that all interested may not only express their opinions on the concepts involved but may also suggest formulations on various aspects of Company Law. This was a laudable step and has evoked considerable response. Comments and suggestions from a large number of organizations, professional bodies and individuals have been received. This consultative process will not only allow ideas, comments and suggestions to flow in from all quarters, but will also enable the Government to work out appropriate legislative proposals to meet the requirements of India's growing economy in the years to come.

7. The Government, therefore, felt it appropriate that the proposals contained in the Concept Paper and suggestions received thereon be put to merit evaluation by an independent Expert Committee. The present Committee was constituted on 2nd December, 2004 under the chairmanship of Dr. J J Irani, Director, Tata Sons, with the task of advising the Government on the proposed revisions to the Companies Act, 1956. The objective of this exercise is perceived as the desire on the part of the Government to have a simplified compact law that will be able to address the changes taking place in the national and international scenario, enable adoption of internationally accepted best practices as well as provide adequate flexibility for timely evolution of new arrangements in response to the requirements of ever-changing

business models. It is a welcome attempt to provide India with a modern Company Law to meet the requirements of a competitive economy.

8. The Expert Committee consists of 13 members and 6 special invitees drawn from various disciplines and fields including trade and industry, chambers of commerce, professional institutes, representatives of Banks and Financial Institutions, Sr. Advocates etc. Government Ministries as well as regulatory bodies concerned with the subject were represented through special invitees. The Committee thus brings to bear a wide range of expertise and experience on the issues before it. In the exercise taken up by it, the Committee took the Companies Act, 1956, as amended, as the base and adopted the following approach:

i) Taking note of the Concept Paper and suggestions/objections and comments on the same received from various quarters, to enable synthesis of opinion on the desirable features of the new law;

ii) Identifying the essential ingredients to be addressed by the new law, retaining desirable features of the existing framework, segregating substantive law from the procedures to enable a clear framework for good corporate governance that addresses the concerns of all stakeholders equitably.

iii) Making recommendations to enable easy and unambiguous interpretation by recasting the provisions of the law so as to enable easy understanding and interpretation;

iv) Enabling greater flexibility in procedural aspects through rule making, so that with the change of time the legal framework may adapt without amendment of the substantive enactment, which would be a time consuming process;

v) Addressing the concerns arising out of the experience of the stock market scams of the 1990s, the phenomenon of vanishing companies and recommendations made by Joint Parliamentary Committee on Stock Market Scam;

vi) Enabling measures to protect the interests of stakeholders and investors, including small investors, through legal basis for sound corporate governance practices.

vii) Providing a framework for responsible self-regulation through determination of corporate matters through decisions by shareholders, in the background of clear accountability for such decisions, obviating the need for a regime based on Government approvals;

viii) Recognizing the relevance of a climate that encourages people to set up businesses and make them grow, addresses the practical concerns of small businesses so that people may deal with and invest in companies with confidence, promotes international competitiveness of Indian businesses and provides it the flexibility to meet the challenges of the global economy.

## Chapter II : Approach of new Company Law

### Nature and Coverage of the Companies Act

1. During the course of its deliberations the Committee considered the desirable scope and coverage of the Companies Act. Many views were expressed, including the view that administration of the legal framework in respect of certain specified companies, such as listed companies, should be de-linked from the Companies Act and entrusted to specialized regulating agencies, e.g., the capital market regulator. Views were also expressed that it was not feasible for an enactment containing general governance principles to address the specialized requirements of operation of entities in the new environment. After considering these views at length, we are of the view that such opinions do not take into account the nature and scope of corporate governance, which goes far beyond actions limited to any specialized activity, say, for instance, access to capital. Comparisons of the Indian situation with the practice in some other jurisdictions, taken out of context, would also not be well-merited. For instance, in some jurisdictions, the federating entities enact their own independent Company Law. The wide mandate provided to the capital market regulator in such a situation, enables access to capital by corporate entities across the length and breadth of the country on the basis of common norms. Similarly, recent enactments in many countries cannot be seen in isolation to the judicial system and its associated processes in such countries. The impact of such legislation in terms of compliance costs imposed on corporates is yet another issue that would need to be addressed keeping in view the relevant environment.

2. Indian corporates do not face a similar situation as prevailing in some other countries since the Indian Companies Act is a central legislation. It should appropriately remain so. The "sovereign vacuum" created by withdrawal of the Central Government from any area of corporate operation and entrustment of the same entirely to a regulator may generate demands in the Indian Federal system for State legislations on the subject, which we feel could lead to duplication and confusion. Further, regulatory urge to control corporate governance often becomes intrusive, posing serious regulatory risks in addition to inhibiting the freedom for decision making necessary for corporate functioning.

3. The extent to which models in operation in various other countries are relevant to the Indian situation needs to be carefully examined before any aspect is incorporated in the Indian framework. While emphasizing the need for incorporating international best practices, we feel that there is a need to develop an Indian model, suitable to the Indian situation, that provides an adequate solution to the pressing concerns of corporate operation, without affecting the efficiency or competitiveness of business in India.

4. Corporate entities should be able to refer to a compact, easily understood, comprehensive compilation of legal requirements before they start operation. It would not be appropriate to develop different frame works for corporate entities on the basis of their size, nature of operations, manner of raising capital etc. Business entities keep on changing their form and structure from time to time as they grow and also need to

adapt to the changing business environment in response to competition, technological change and requirements of operation in the international arena. Presence of differently administered frameworks would be an obstruction to change. This would also result in inter-agency overlaps and conflicts of jurisdiction. Besides, each framework would have its own compliance structure, leading to duplication of effort on the one hand and uncertainties and regulating risk for the corporates on the other. Eventually it would make adaptation to change slow and compliance costly.

5. We are therefore of the view that in the Indian context, it is important that the basic principles guiding the operation of corporate entities from registration to winding up or liquidation should be available in a single, comprehensive, centrally administered frame work. This is important for the law and practice in corporate law to evolve and to bring about necessary reforms in the application of the framework. We hold the view that this would not deny the space to sectoral regulators to regulate behaviour of entities in their respective designated domains. Rather this would enable the regulators to concentrate their resources in a more focused manner on the substantive issues affecting their respective sectors.

6. Further, we are of the view that the legal framework for corporate governance and operation should provide a smooth and seamless transition from one form of business entity to another. Therefore, we recommend a single corporate law framework for application to all companies. The requirements of special companies e.g. small companies, could be recognized through a scheme of exemptions.

**Law and adaptation to changing circumstances**

7. The existing Companies Act, 1956 is a voluminous document with 781 sections. It also contains provisions that cover aspects which are essentially procedural in nature. In certain areas, it prescribes quantitative limits which are now irrelevant on account of changes that have taken place over a period of time. This format has also resulted in the law becoming very rigid since any change requires an amendment of the law through the parliamentary process. Therefore, the law has failed to take into account the changes in the national and international economic scenario speedily. As a result, in some quarters, it is being regarded as outdated. However, this need not be the case since many essential features of corporate governance which are already recognized in the Companies Act, 1956 need to be retained and articulated further. What is required is that along with the changes in the substantive law, wherever required, a review of procedural aspects may also be undertaken so as to enable greater degree of self-regulation and easy compliance. Therefore, we recommend that the Company Law may be so drafted that while essential principles are retained in the substantive law, procedural and quantitative aspects are shifted to the rules. This would enable the law to remain dynamic and to adapt to the changes in business environment.

**Growth of the corporate regulatory framework**

8. We feel that the corporate operation, which is complex, cannot in fact be completely regulated by a single set of legal principles. It is clear that in the times to come, a large body of regulatory pronouncements, governance codes and standards will complement the principles which are laid down in the law. Regulatory and professional bodies have an extremely important role to play in this regard. However, such pronouncements have to be consistent with the underlying law. A case in point is

the harmonious evolution of the accounting standards in India to keep pace with the international developments and the manner in which it has been facilitated by the Companies Act, 1956. Such mechanism will have to dovetail with the Companies Act so as to expand its coverage in a meaningful manner while allowing a modality for improvements over time.

**Regulatory overlap**

9. Perception in some quarters as to the need to demarcate the respective jurisdictions of Ministry of Company Affairs (MCA) and SEBI has come to our notice. In our view, this perception is misplaced. In so far as, the legal framework is concerned, the Central Government is represented through a Ministry which would be required to exercise the sovereign function and discharge the responsibility of the State in corporate regulation. SEBI, on the other hand, is a capital markets regulator having distinct responsibilities in regulation of the conduct of intermediaries capital market and interaction between entities seeking to raise and invest in capital.

10. We do not subscribe to the view that corporates seeking access to capital need to be liberated from their responsibilities under all other laws of the land and , thereby the oversight by the State, and be subjected to exclusive control and supervision of a specific regulator. Corporates have to function as economic persons within the Union of India in a manner that contributes to the social and economic well being of the country as a whole and as such must be subject to the laws pronounced by the Parliament for the welfare of its citizens.

11. Corporate Governance goes far beyond access to capital. Taking a narrow view of Corporate Governance as limited to public issue of capital and the processes that follow would be to the detriment of corporate entities themselves. Equally, the capital market regulator has to play a central role in public access to capital by the companies and must have he necessary space to develop suitable frameworks in tune with the fluidity of the capital markets.

12. To our mind, with the substantive law being compiled to reflect the core governing principles of corporate operations and separation of procedural aspects, it would be possible for the Regulator to provide the framework of rules for its domain consistent with the law. Such rules would be complementary to the legislated framework and there would be no overlap or conflict of jurisdiction between regulatory bodies. We therefore recommend a harmonious construction for operation of the State and regulatory agencies set up by it.

**Framework for small enterprises**

13. The Committee recognized that the Indian economy is yet in its growing phase. The number of companies being set up will increase over a period of time as new business opportunities emerge and new technological frontiers are scaled. Many new companies will be set up as small companies who will grow big in the future. It is clear that the small companies would contribute significantly to Indian economy. Because of their size, they cannot be burdened with the same level of compliance requirements as, say, the large public listed companies. The small companies have to be enabled to take quick decisions, be adaptable and nimble in the changing economic environment, yet be encouraged to comply with the essential requirements of the law through low

cost of compliance. The Government may prescribe special regime for such companies through a system of exemptions.

## <u>Institutional Structure</u>

14. Corporate issues will also require a quick resolution. The time taken in the existing framework needs to be reviewed. This is particularly so in the context of rehabilitation, liquidation and winding up. Mergers and amalgamations also need to be facilitated to take place through a speedier process. Through the Companies (Second Amendment) Act, 2002 the Government has envisaged setting up of the National Company Law Tribunal and the National Company Law Appellate Tribunal. We welcome this move. It is time the forum with specialization to deal with corporate issues, bringing together expertise from various disciplines, is established. We are informed that there are certain legal issues to be resolved before these institutions can be set up. We hope that this process is speedily concluded so that a single forum is available for an informed consideration of corporates issues.

## Chapter III : Classification and Registration of Companies

1. The Companies Act, 1956 broadly classifies the companies into private and public companies and provides for regulatory environment on the basis of such classification. However, with the growth of the economy and increase in the complexity of business operation, the forms of corporate organizations keep on changing. There is a need for the law to take into account the requirements of different kinds of companies that may exist and seek to provide common principles to which all kinds of companies may refer while devising their corporate governance structure. Rigid structures, unnecessary controls and regulations inhibit the risk taking initiatives of the entrepreneurs. Private companies and small companies, who do not generally go for public issues or deposits for their financial requirements but utilize their personal or in-house resources, need to be given flexibility and freedom of operation and compliance at a low cost. Equally, public companies that access capital from public need to be subjected to a more stringent regime of corporate governance. To enable a comprehensive framework for different forms of corporate organizations, the Company Law should ensure multiple classifications of companies. It should also enable smooth change-over of companies from one type to another.

### Classification of Companies

2. The corporate form can take many shapes in order to respond efficiently to the environment. Company Law should therefore recognize a multiple classification of companies. The Committee indicates the criteria for classification on the basis of the forms discernible today, but recognizes that such classification can never be exhaustive.

i) On the basis of size:

a) Small companies
b) Other companies

ii) On the basis of number of members:

a) One person company
b) Private companies
c) Public companies

iii) On the basis of control

a. Holding companies
b. Subsidiary companies
c. Associate companies

iv) On the basis of liability

a) Limited

I) by Shares

II) by Guarantee (with or without share capital)

b) Unlimited

v) On the basis of manner of access to capital

a] Listed companies
b] Un-listed companies

3. The law should recognize the potential for diversity in the forms of companies and rather than seeking to regulate specific aspects of each form, seek to provide for principles that enable economic inter-action for wealth creation on the basis of clear and widely accepted principles.

**Small companies**

4.1 The Committee sees no reason why small companies should suffer the consequences of regulation that may be designed to ensure balancing of interests of stakeholders of large, widely held corporates. Company law should enable simplified decision making procedures by relieving such companies from select statutory internal administrative procedures. Such companies should also be subjected to reduced financial reporting and audit requirements and simplified capital maintenance regimes. Essentially the regime for small companies should enable them to achieve transparency at a low cost through simplified requirements. Such a framework may be applied to small companies through exemptions, consolidated in the form of a Schedule to the Act.

4.2 Law could also consider an integrated approach whereby a deregulated framework for private companies may be provided, which may also apply to small companies. However a definition of small companies may be considered for enabling such a regime. There are bound to be problems associated in prescribing size. In our view, size may be assessed on the basis of gross assets comprising of fixed assets, current assets and investments not exceeding a particular limit as also turnover. Since the definition of “small” may change over time, this may be done through rules.

4.3 To qualify for exemptions, a small company should however neither be a holding nor a subsidiary of any other company. However, the Committee does not feel the need for providing a special internal governance and constitutional regime to small companies. This is likely to come in the way of their future growth. Instead the Committee recommends enabling of new vehicles for business, such as Limited Liability Partnerships, through separate legislation, if necessary.

4.4 Associations, Charitable Companies etc. licensed u/s 25 of the existing Companies Act, should not be treated as small companies irrespective of their gross assets.

4.5 The law should provide a framework compatible to growth of small corporate entities. Exemptions should however facilitate compliance by small companies in an easy and cost effective manner. These should not incentivize concealment of true size by any entity or be a barrier to growth of small companies.

**Private Companies**

5. Private companies represent a different set of relationships in terms of ownership, risk and reward as compared to public companies. Since private companies, do not access capital markets, they require less rigorous protection for their shareholders. They however represent an important organizational form for conduct of business. Therefore there is a case for lighter regulatory overhang over private companies. The existing law provides for certain relaxations to private companies on account of their nature. We are of the view that this approach should be continued and amplified where appropriate. While good Corporate Governance is equally important for success of such private companies, the obligation for dissemination of information of corporate process should be so structured that such enterprises do not lose the flexibilities in conduct of their business. In particular, the law should enable a private company to take any decision it is otherwise empowered to take, without observing the formalities of the Act if the members of the company unanimously agree. A simplified circular resolution procedure should also be considered where unanimity is not possible. Since disputes may also arise amongst the members of such companies, the costs of which may ruin the company, the regime for private companies should contain dispute resolution procedures, simplified to the extent possible.

**One Person Company (OPC)**

6. With increasing use of information technology and computers, emergence of the service sector, it is time that the entrepreneurial capabilities of the people are given an outlet for participation in economic activity. Such economic activity may take place through the creation of an economic person in the form of a company. Yet it would not be reasonable to expect that every entrepreneur who is capable of developing his ideas and participating in the market place should do it through an association of persons. We feel that it is possible for individuals to operate in the economic domain and contribute effectively. To facilitate this, the Committee recommends that the law should recognize the formation of a single person economic entity in the form of 'One Person Company'. Such an entity may be provided with a simpler regime through exemptions so that the single entrepreneur is not compelled to fritter away his time, energy and resources on procedural matters.

6.1 The concept of 'One Person Company' may be introduced in the Act with following characteristics :-

a) OPC may be registered as a private Company with one member and may also have at least one director;

b) Adequate safeguards in case of death/disability of the sole person should be provided through appointment of another individual as Nominee Director. On the demise of the original director, the nominee director will manage the affairs of the company till the date of transmission of shares to legal heirs of the demised member.

c) Letters ‘OPC’ to be suffixed with the name of One Person Companies to distinguish it from other companies;

**Government Companies**

7.1 In general, there is little justification for Government companies being provided relaxations in compliance with company law. It is even less if such companies are listed. Not only should such Government companies be able to compete in the market economy with other companies on equal terms, it would not be fair to the investors or creditors if such entities are allowed to present their performance on the basis of dissimilar parameters.

7.2 Government companies may be subject to imposition of non-commercial/ commercially unviable social responsibilities. However the costs of such responsibilities should be transparently assessed and provided by the Government through the budget as a subsidy. It is not appropriate that application of the law or standards be relaxed to allow such costs to be incurred in a non-transparent manner.

7.3 There may be situations where such companies may require special treatment in activities related to the security of State. There may be an enabling provision to relax operation of Companies Act for such companies. Other companies, engaging in commercial activity should compete on the basis of transparency and level playing fields. Preferential treatment to such companies would be to the detriment to the capacity of Indian companies to survive in a competitive market.

7.4 A Government company should be clearly defined in law. It should be one where there is a clear majority stake held by the state- i.e. Central and/or State Government(s). There is no rationale for the definition of Government company being extended to companies set up by Government companies in course of their commercial activities.

**Holding and Subsidiary Companies**

8.1 The Companies Act should not pre-empt the decision as to what structure is appropriate for controlling businesses. Such prescriptions will make the environment rigid and put Indian companies at a disadvantage vis-à-vis their competitors internationally. Such restrictions would also not facilitate sound corporate planning, formation of joint ventures, international operations or restructuring of companies.

8.2 Therefore, we are of the view that there may not be any restriction to a company having any number of subsidiaries, or to such subsidiaries having further subsidiaries. However, the Act should provide for a clear definition of both the holding as well as subsidiary body corporate. In doing so, formation of subsidiary structures through control by a holding company, directly, indirectly or through one or more subsidiaries should be taken into account, keeping in view international practices.

8.3 The need to provide for transparency and to control misuse of funds through transfers from one company to another, including subsidiaries, has to be recognized. However, it needs to be recognized that the phenomenon of siphoning off funds may not be caused solely on account of holding-subsidiary structure. Companies may use other routes/structures/associate companies to siphon off funds. Isolated instances of misuse of the holding-subsidiary structure should not result in doing away with this very important business model for investment and corporate planning. Instead of prohibiting formation of subsidiaries, there should be adequate disclosure obligations as to utilization of the funds raised or loans and advances given by the company to other entities. Strict disclosure and compliance norms in respect of holding and subsidiary company structures should be provided for.

8.4 The Committee is of the view that proper disclosures accompanied by mandatory consolidation of financial statements should address the concern attendant to the lack of transparency in holding-subsidiary structure.

8.5 There may be further provisions that the transactions between holding and subsidiary company may be treated as related party transactions and placed before the Board through the Audit Committee, where such a Committee exists. Transactions not in the ordinary course of business and/or not on arms length basis between the holding and subsidiary company, should be disclosed in the annual report along with management justification thereof.

8.6 In its examination of this issue, the Committee also considered the recommendations made by the JPC on Stock Market Scam on restricting the layers of subsidiary investment companies. The Committee noted that these recommendations were in context of the stock market / banking scams witnessed in India over the past decade. At the same time, it was argued that the creation of subsidiaries for separate manufacturing entities, joint ventures was a reality and there were no restrictions on foreign companies operating internationally. Even banks may have to set up subsidiaries for their Non Banking / Joint Venture companies engaged in insurance, asset management etc. In the present situation, when Indian companies were seeking to make investments abroad, such restriction would adversely affect their opportunities in face of international competition. During deliberations, it was felt that protecting legitimate business activity under a regime for setting up subsidiary companies would result in special carve outs and monitoring the activities of such companies would become an administrative nightmare. For these reasons, the Committee took the view that limiting the layers of subsidiary investment companies was not feasible. Instead, a regime for preventing misuse of this mechanism should be devised based on transparent Board processes and disclosures under close supervision of the regulator for listed companies.

**Producer Companies**

9.1 The administration and management of 'Producer Companies' is not in tune with general framework for companies with liabilities limited by shares/guarantees. The shareholding of a 'Producer Company' imposed restrictions on its transferability, thereby preventing the shareholders from exercising their exit options through a market determined structure. It was also not feasible to make this structure amenable to a competitive market for corporate control.

9.2 If it is felt that producer companies are unable to function within the framework and liability structure of limited liability companies. The Corporate Governance regime applicable to companies could not be properly imposed on this form. Government may consider introduction of a separate Act to deal with the regulation of such 'Producer Companies'. Part IX A in the present Companies Act, which has hardly been resorted to and is more likely to create disputes of interpretation and may, therefore, be excluded from the Companies Act.

**Joint Venture/shareholders Agreements**

10.1 Capital and Technology in the modern world move into companies through joint venture opportunities. The ability to access technology, know-how, business, trade-marks and other intellectual property or service rights is critically linked with the law on joint ventures.

10.2 Over the years, several court judgments have been pronounced in India on the issue of validity of joint venture covenants. As per the judicial view, recognition to such covenants through corporate action is possible only if they are made part of the Articles of Association of a company. However, in this form, they are subjected to the overriding effect of Section 9 of the Companies Act, 1956. Thus, while joint venture agreements may take place and provide for certain exclusionary or extra-ordinary clauses pertaining to interventions by the joint venture partners, such exclusions are not generally compatible with the present Companies Act. They are, however, recognized under Contract Law. The effect of this framework is that dispute resolution in respect of joint venture provisions becomes subject to contract law provisions and is subject to lengthy arbitration. The companies however, prefer that such aspects should be addressed more speedily through the corporate processes.

10.3 There is an inherent inconsistency of the joint venture form with the provision of Section 111 A of the Companies Act, 1956 also which would need to be addressed if the facility of corporate based redressal mechanism is to be made available for joint ventures. It was noted that joint venture agreements have several clauses pertaining to voting rights, additional quorum requirements, arbitration provisions ousting statutory remedies, pre-emption rights or restrictions on transfer of shares.

10.4 It was represented before the Committee that there should be an appropriate exception to the doctrine of ultra vires under Section 9 of the Companies Act and the parties should have "party autonomy of contract" in their joint venture documentation. This would however imply that any third party dealing with any or either of named shareholders would have an obligation and a consequent right to seek disclosure and must verify the fullness of fact and terms contracted between the joint venture partners through shareholders agreements before dealing with the shares. Equally the

Committee noted the concern that company law should not include provisions that provide “fly out” opportunities to companies seeking to evade its provisions. Nor could company law address the shortcomings of other legal regimes, the costs associated with arbitration and litigation that would need to be undergone to enforce contracts.

10.5 The Committee, after considering various aspects is of the view that in the current context, it would be appropriate to provide for a framework that would enable Indian entities to access greater opportunities through joint ventures while reform of the legal system to address difficulties faced in administration of civil law must continue. A transparent modality for providing recognition to agreements between joint venture partners for corporate action should be worked out in Company Law, keeping in view the concern that such arrangements should not become a window for circumventing the essential provisions of the Law.

10.6 The Committee is of the view that this conflict needs to be resolved since such restrictions under the Company Law will adversely affect the free-flow of capital and technology into the country in times to come. Therefore, a suitable provision should be incorporated under the new Company Law recognizing such arrangements between two or more substantial shareholders or joint venture partners.

**Public Financial Institutions (PFIs)**

11.1 Through the amendment in 1974, a new Section 4A {“Public Financial Institutions [PFIs]} was inserted in the Companies Act, 1956. This section defined certain institutions as PFIs and empowered Central Government (MCA) to notify, from time to time, other institutions PFIs. About 46 institutions have been declared as PFIs under this Section by the MCA. Though this term has been defined under the Companies Act, 1956, the term has been used and referred in many Acts and a number of benefits (economic as well as other) are available to such PFIs under Companies Act and other Acts/delegated legislations.

11.2 In view of changing competitive economic environment and continuous reforms in financial sector, a need has been felt for review of the concept of PFI. It is being felt in certain quarters that this concept should be deleted, with suitable transitory provisions in respect of existing PFIs. Suitable steps to take care of provisions in other Acts/delegated legislations, which are using this term should also be taken. Besides, there does not appear to be any logic for addressing such a concept (relating to Financial Institutions) in the Companies Act. The Companies Bill, 1997 had, therefore, proposed for shifting of this concept to PFI (Obligations as to Fidelity and Secrecy) Act, 1983, which is administered by Ministry of Finance.

11.3 They should be subject to similar regulatory provisions. There is no reason why a relaxed framework in respect of corporate governance should be provided to such institutions through exemptions in provisions of company law. Such institutions should be put through similar requirements of financial and management prudence as other FIs. Therefore, the Committee does not see any reason why the special regime for Public Financial Institutions provided under the Companies Act, 1956, should continue.

**Incorporation**

12.1 The process of incorporation through registration should be based on correct information to be disclosed by the promoters of the company with full liability towards its correctness. The information necessary for registration may be prescribed through rules. However, the contents of the Memorandum of Association should be part of the substantive law and not in the Rules. Process of registration should be speedy and compatible with e-Governance initiative taken up by the Government.

12.2 The companies should be required to make and authenticate detailed disclosures about promoters, directors of the company at the time of incorporation. These disclosures should be prescribed to be made in a manner that allows for additions/changes, keeping pace with the developments in the company.

12.3 The Promoters and Directors should disclose information that establishes/authenticates their proof of residence and identity through supporting documents such as Photographs, PAN Number, Passport, affidavits etc. that may be prescribed.

12.4 Every company should be obliged to have a registered office and to disclose it correctly along with proof of address, in a manner that enables access physically and by service of post. The companies should also be made to register their websites and e-mail addresses.

12.5 The primary responsibility for veracity of statements made should be that of promoters/ first directors. If agents or professional are empowered, this should be on the basis of suitable power of attorney and should not relieve the principals of their liability. Stringent penalties should also be provided for any professionals, if engaged, who do not exercise due diligence at the time of incorporation.

12.6 Directorships by the promoters/directors in other companies should be declared at the time of incorporation. The terms ‘Promoters’ and ‘control’ should be clearly defined for avoiding any doubts.

12.7 Stringent consequences should follow if it is found that incorporation has been done under false or misleading information.

**Shifting of Registered Office**

13. The present procedure requires the Registered office of a company being shifted from one state to another subject to order of CLB. The Committee expressed its concern at the delays and costs involved in the process. Besides, corporates should be afforded the opportunity of beneficial business environments if available in different parts of the country. A view was expressed that this decision should be left to the shareholders. However, the Committee also recognized that interests of other stakeholders would be involved. The Committee felt there was an urgent need for making this process simpler, faster and easier, without reference to a Tribunal/Court, ensuring that the new registered office is accessible to stakeholders for legal recourse, where necessary.

**Vanishing companies**

14.1 The Committee is seriously concerned at the phenomenon of companies that vanished after raising funds from the public, thereby cheating investors. This has resulted in a lack of credibility not only on the part of the companies but also of the institutional structure regulating such entities and enforcement agencies. We understand that the Central Government is now pursuing action against such companies through a coordinated mechanism involving both the Ministry of Company Affairs and SEBI. However, a lot requires to be done to prevent such phenomenon. We feel that such preventive action should begin with registration itself and should be sustained through a regime that requires regular and mandatory filing of statutory documents. With introduction of electronic filing, this process would become convenient to companies as well as the stakeholders. Behaviour resulting in non-filing of documents or incorrect disclosures should be dealt with strictly.

14.2 Information provided at the time of registration should determine the addresses of the company as well as its directors. It should be the duty of the Company to intimate any change of address within a fixed time period.

14.3 There should also be a system of random scrutiny of filings of corporates to be carried out by the registration authorities with heavy penalties for the companies found inadequate in their disclosures and filings.

14.4 Inter agency coordination should be enabled to track down the persons behind such companies to bring them to book. Law should be amended to make them disgorge their ill-gotten gains by lifting the corporate veil.

## Incorporation- Allied Issues

### e-Governance

15.1 The Committee takes note of the e-governance initiative launched by MCA and recommends that it be implemented speedily. It recognized the immense potential of this programme to bring about ease of compliance at a lower cost. However, the Committee observes that e-Governance should be cost-effective to companies, including Small and One Person Companies, easy to use and accessible to all stakeholders and general public and enable the process of registration and filing for disclosures and retrieval of data efficiently and at a low cost. Further, the system should have adequate capacities to handle the likely growth in the corporate sector in India in the years to come as well as the increase in disclosure requirements that may be mandated by the legal and regulatory framework.

15.2 All statutory filings should be made compatible to e-filing by devising suitable e-forms. Such filings should be kept securely and should be identifiable through digital signatures.

15.3 The e-Governance system should enable quick disposal of the registration and incorporation processes with the use of self operating e-systems, minimizing physical interface and use of discretionary statutory powers by registering authorities.

15.4 All companies should be required to specify authorized signatories with authority to sign and authenticate filings digitally.

15.5 On-line filing and levy of charges etc. should be made easy. Once the system has established its effectiveness, it may be made mandatory for all the companies.

15.6 An effort should be made to resolve stamp duty issues between the Central and State Governments so that in times to come, law may recognize the concept of single national registry.

15.7 The Companies Act should provide a suitable legislative frame work for levy of user charges. Such charges should be reasonable to enable the operation of the e-governance initiative in a sustainable manner.

### Name allotment

16.1 Other incorporation processes such as name allotment etc. should be made simpler and amenable to be completed through automatic e-systems. The Committee is of the view that the process of incorporation and registration should be competitive with developed economies of the world.

16.2 There may be reasonable prohibitions imposed under the Act on the use of certain names. The Government should retain powers to prevent companies having names that give the impression that the company is in any way connected with the Central / State Government or with a local authority.

16.3 There should be power in law to require a company to abandon misleading names or to trade under a misleading name.

16.4 The regime for change of name should be carefully reviewed. While providing the freedom to a company to change its name it should prevent too frequent a change of name to prevent cheating / misleading of stakeholders/ investors.

**Restrictions on commencement of business** :

17.1 Companies Act, 1956 provides for restrictions on commencement of business by public companies or exercise of any borrowing powers, unless the requirements of capital subscription by the numbers of the company have been met. Additionally, there is a requirement for issue of Commencement of Business Certificate by the Registrar of Companies (ROC).

17.2 It appears that issue of a certificate of commencement of business would not be necessary since present Companies Act prescribes the amount of capital to be paid up immediately after the registration. This should be adequate to establish the borrowing power of the company. In view of this, the requirement of obtaining a separate Certificate of Commencement of business imposes avoidable delay and could be dispensed with.

**Limited liability Partnership (LLP)**

18.1 In view of the potential for growth of the service sector, requirement of providing flexibility to small enterprises to participate in joint ventures and agreements that enable them to access technology and bring together business synergies and to face the increasing global competition enabled through WTO, etc., the formation of Limited Liability Partnerships (LLPs) should be encouraged.

18.2 It would be a suitable vehicle for partnership among professionals who are already regulated such as Company Secretaries, Chartered Accountants, Cost Accountants, Lawyers, Architects, Engineers, Doctors etc. However, it may also be considered for small enterprises not seeking access to capital markets through listing on the stock exchange.

18.3 We recommend that a separate Act be brought about to facilitate limited liability partnerships. The concept need not be addressed in Companies Act.

**Limitation on Number of Partners specified in the Companies Act.**

19.1 The Committee recognizes that there are many forms of association that would facilitate business operation. It also recognizes the relevance of proprietorship and partnership firms in this regard. While the corporate form of organization would provide greater clarity to the stake holders and entities interacting with the business firm, the Companies Act need not compel limitations on other forms of organizations. This should be left to be specified or regulated through the respective legislations relating to such forms. Therefore, there may be a need for review of the Partnership Act. The Companies Act however need not make any prescriptions in this regard.

19.2 Therefore, provisions limiting the number of partners as provided in the Section 11 of the Companies Act should be deleted. Necessary provisions in this regard may be included in the Partnership Act or other related Acts.

**Special Regime for Charitable and other Companies (Sec.25)**

20.1 There is a need for transparency in functioning of such companies. Objects of such companies should be clearly defined.

20.2 Framework for remuneration should be such that it does not result in siphoning of the company's funds.

**Simplification of the regime for exit of companies from the Register of Companies**

21.1 The Committee noted that the Register of Companies includes a very large number of defunct companies. There is a cost associated with carrying the information of such companies on the public register. This cost can be avoided.

21.2 The procedure for a company seeking exit from the Register of Companies needs to be simplified. This should not require operation of special schemes for providing exit to companies through relaxation of rules. This should be possible through normal operation of the law. The law should enable Registrars of Companies to use suo moto powers to strike off names of defunct companies (a company which is not carrying on business or any operation) effectively. They should also be empowered to strike off the names of companies from the Register of Companies on application for the purpose by the company directors or majority of them. The application form to be prescribed should be simple. On receipt of such application, Registrar should issue a public notice about his intention to exercise the power to strike off the name of the company and also invite public comments on why he should not do so, to be indicated in a time-bound manner, after which consent may be presumed.

21.3 Such application may however not be made if at any time during the previous 6 months, the company has changed its name, traded or otherwise carried on any business. The orders by the Registrar striking off the name of the company from the Register should again be issued in the form of a public notice and should take automatic effect on expiry of prescribed period. Public notice may be given by way of placing on the notice board / web site of the registration authorities and sent to the company as well as to its last known directors by registered post.

## **Chapter IV** : **Management and Board Governance**

1. The Board of Directors has to exercise strategic oversight over business operations while directly measuring and rewarding management's performance. Simultaneously the Board has to ensure compliance with the legal framework, integrity of financial accounting and reporting systems and credibility in the eyes of the stakeholders through proper and timely disclosures.

2. Board's responsibilities inherently demand the exercise of judgment. Therefore the Board necessarily has to be vested with a reasonable level of discretion. While corporate governance may comprise of both legal and behavioral norms, no written set of rules or laws can contemplate every situation that a director or the board collectively may find itself in. Besides, existence of written norms in itself cannot prevent a director from abusing his position while going through the motions of proper deliberation prescribed by written norms. Therefore behavioural norms that include informed and deliberative decision making, division of authority, monitoring of management and even handed performance of duties owed to the company as well as the shareholders are equally important.

3. However in a situation where companies have grown in size and have large public interest potential, it is important to prescribe an appropriate basic framework that needs to be complied with by all companies without sacrificing the basic requirement of allowing exercise of discretion and business judgment in the interest of the company and the stakeholders. The liability of compliance has to be seen in context of the common law framework prevalent in the country along with a wide variety of ownership structures including family run or controlled or otherwise closely held companies.

### **Board of Directors**

4. Obligation to constitute a Board of Directors :-

4.1 The Board of Directors of a company is central to its decision making and governance process. Its liability to ensure compliance with the law underpins the corporate governance structure in a company, the aspirations of the promoters and the rights of stakeholders, all of which get articulated through the actions of the Board. There should be an obligation on the part of a Company to constitute and maintain a Board of Directors as per the provisions of the law and to disclose particulars of the Directors so appointed in the public domain through statutory filing of information.

4.2 Such obligation should extend to the accuracy of the information and its being updated regularly as well as on occurrence of specific events such as appointment, resignation, removal or any change in prescribed particulars of Directors.

## Minimum and Maximum Number of Directors

5.1 Law should provide for minimum number of directors necessary for various classes of companies. The present prescribed requirement is considered adequate. However new kinds of companies will evolve to keep pace with emerging business requirements. Law should therefore include an enabling provision to prescribe specific categories of companies for which a different minimum number may be laid down

5.2 The obligation of maintaining the required minimum number of directors on the Board should be that of the Company

5.3 There need not be any limit to the maximum numbers of directors that a Company may have. Limit to maximum number of directors should be decided by the company by/in the Articles of Association.

5.4 Every Company should have at least one director resident in India to ensure availability in case any issue arises with regard to the accountability of the Board.

## Manner of appointment, removal and resignation of Directors

6.1 The ultimate responsibility to appoint/remove directors should be that of the Company (Shareholders). If the Directors themselves are legally disqualified to hold directorships, they should have an equal responsibility for disclosing the fact and reasons for their disqualification.

6.2 Government should not intervene in the process of appointment and removal of Directors in non-Government companies. It is important that role and powers of Government, under the present provisions to intervene in appointment of Directors be reviewed and revised, vesting the responsibility on the shareholders of the company.

6.3 Presently, as per the provisions of Schedule XIII to the Companies Act, it is necessary to obtain the approval of the Central Government for appointing a person who is not resident in India, i.e. a person who has not been staying in India for a continuous period of not less than 12 months immediately preceding the date of his appointment as a managerial person.

6.4 In today's competitive environment, it may be necessary for a company to appoint a person as Managing Director or Whole-time Director or Manager who is "best suited for the job". The Company should, therefore, have an option to choose such person not only from within India, but from other countries as well. In the light of the above, it is recommended that requirement of obtaining the Central Government's approval under the Companies Act for such non-resident managerial person should be done away with. Such person would continue to be subject to passport/visa, RBI and other Government requirements.

6.5 Duty to inform ROC of particulars regarding directors including their appointment and removal/ resignation/ death, or otherwise ceasing to be Directors should be with the company. Every Director, in turn, should be required to disclose his residence and other particulars, as may be prescribed, to the Company.

6.6 Resignation should be recognized as a right to be exercised by the director and should be considered in light of the recommendations indicated at para 21.1-21.8 below).

**Age limit for Directors**

7.1 No age limit need be prescribed as per law. There should be adequate disclosure of age in the company's documents. It should be the duty of the Director to disclose his age correctly.

7.2 In case of a public company, appointment of directors beyond a prescribed age say 70 years, should be subject to a special resolution by the shareholders which should also prescribe his term. Continuation of a director above the age of 70 years, beyond such term, should be subject to a fresh resolution.

## Independent Directors

### The Concept and Numbers of Independent Directors

8.1 The Committee is of the view that given the responsibility of the Board to balance various interests, the presence of Independent directors on the Board of a Company would improve corporate governance. This is particularly important for public companies or companies with a significant public interest. While directors representing specific interests would be confined to the perspective dictated by such interests, independent directors would be able to bring an element of objectivity to Board process in the general interests of the company and thereby to the benefit of minority interests and smaller shareholders. Independence, therefore, is not to be viewed merely as independence from Promoter Interests but from the point of view of vulnerable stakeholders who cannot otherwise get their voice heard. Law should, therefore, recognize the principle of independent directors and spell out their role, qualifications and liability. However requirement of presence of Independent directors may vary depending on the size and type of company. There cannot be a single prescription to suit all companies. Therefore number of Independent directors may be prescribed through rules for different categories of companies. However a definition of independent director should be incorporated in the Company law.

8.2 In general, in view of the Committee a minimum of one third of the total number of directors as independent directors should be adequate for a company having significant public interest, irrespective of whether the Chairman is executive or non-executive, independent or not. In the first instance this requirement should be extended to public listed companies and companies accepting public deposits. The requirements for other types of companies may be considered in due course.

8.3 In certain cases Regulators may specify requirement of Independent Directors for companies falling within their regulatory domain. Such Regulators may specify the number where provision for appointment of Independent Directors has been extended to a particular class of companies under the Companies Act.

8.4 Nominee directors appointed by any institution or in pursuance of any agreement or Government appointees representing Government shareholding should not be deemed to be independent directors. A view point was expressed that nominees of Banks/Financial Institutions (FIs) on the Boards of companies may be treated as "Independent". After detailed deliberation, the Committee took the view that such nominees represented specific interests and could not, therefore, be correctly termed as independent.

8.5 There should be no requirement for a subsidiary company to necessarily co-opt an independent director of the holding company as an independent director on its board.

**Definition of Independent Director/ Attributes of Independent Directors**

9.1 The Committee was of the view that definition of an Independent Director should be provided in law.

9.2 The expression 'independent director' should mean a non-executive director of the company who :-

a) Apart from receiving director's remuneration, does not have, and none of his relatives or firms/companies controlled by him have, any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associate companies which may affect independence of the director. For this purpose "control" should be defined in law.

b) is not, and none of his relatives is, related to promoters or persons occupying management positions at the board level or at one level below the board;

c) is not affiliated to any non-profit organization that receives significant funding from the company, its promoters, its directors, its senior management or its holding or subsidiary company;

d) has not been, and none of his relatives has been, employee of the company in the immediately preceding year;

e) is not, and none of his relatives is, a partner or part of senior management (or has not been a partner or part of senior management) during the preceding one year, of any of the following:-

i] the statutory audit firm or the internal audit firm that is associated with the company, its holding and subsidiary companies;

ii) the legal firm(s) and consulting firm(s) that have a material association with the company, its holding and subsidiary companies;

f) is not, and none of his relatives is, a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;

g) is not, and none of his relatives is, a substantial shareholder of the company i.e. owning two percent or more of voting power.

9.3 Explanation :-

For the above purposes :-

(i) “Affiliate” should mean a promoter, director or employee of the non-profit organization.

(ii) “Relative” should mean the husband, the wife, brother or sister or one immediate lineal ascendant and all lineal descendents of that individual whether by blood, marriage or adoption.

(iii) “Senior management” should mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

(iv) “Significant Funding” – Should mean 25% or more of funding of the Non Profit Organization.

(v) “Associate Company” – Associate shall mean a company which is an “associate” as defined in Accounting Standard (AS) 23, “Accounting for Investments in Associates in Consolidated Financial Statements”, issued by the Institute of Chartered Accountants of India.

**Mode of Appointment of Independent Directors**

10. The appointment of independent directors should be made by the company from amongst persons, who in the opinion of the company, are persons with integrity, possessing relevant expertise and experience and who satisfy the above criteria for independence.

**‘Material’ Transactions**

11.1 The term material pecuniary relationship should also be clearly defined for the purpose of determining whether the director is independent or not. The concept of “Materiality’ is relevant from the recipient’s point of view and not from that of the company.

11.2 The term ‘material’ needs to be defined in terms of percentage. In view of the Committee, 10% or more of recipient’s consolidated gross revenue / receipts for the preceding year should form a material condition affecting independence.

11.3 For determining materiality of pecuniary relationship, transactions with an entity in which the director or his relatives hold more than 2% shareholding, should also be considered.

11.4 An independent director should make a self-declaration in format prescribed to the Board that he satisfies the legal conditions for being an independent director. Such declaration should be given at the time of appointment of the independent director and at the time of change in status.

11.5 Board should disclose in the Director's Report that independent directors have given self-declaration and that also in the judgment of the Board they are independent. The Board should also disclose the basis for determination that a particular relationship is not material.

**Number Of Directorships and Alternate Directors**

12.1 The total number of Directorships any one individual may hold should be limited to a maximum of **15.**

12.2 The number of alternate directorships a person holds should fall within the overall limit of directorships (Total 15). This is necessitated so that the same person is not an alternate director in a large number of companies which may result in deficiency in discharge of duties.

12.3 An individual should not be appointed as an alternate director for more than one director in the same company.

12.4 An alternate director may be allowed to be appointed for an independent director. However, such alternate director should also be an independent director.

12.5 Same liability structure as would be applicable to Independent Directors should also apply to Alternate Directors to Independent Directors.

**Directors' Remuneration**

13. There is a need for comprehensive revision of provisions of the Companies Act 1956 relating to payment of managerial remuneration.

13.1 Companies need to adopt remuneration policies that attract and maintain talented and motivated directors and employees so as to encourage enhanced performance of the company. Decision on how to remunerate directors should be left to the Company. However this should be transparent and based on principles that ensure fairness, reasonableness and accountability.

13.2 It is important that there should be a clear relationship between responsibility and performance vis-à-vis remuneration, and that the policy underlying Directors' remuneration be articulated, disclosed and understood by investors/ stakeholders.

13.3 Presently managerial remuneration is subject to Government approvals, both in terms of total remuneration permissible and through specified sub-limits. In view of the Committee, emphasis should be more on disclosures (both on quantity and quality) rather than providing limits/ceilings.

13.4 The Committee examined the relevance of Government approvals on managerial remuneration and its application to any class or classes of companies. It was noted that in the current competitive environment, where Indian companies would be competing for specialized man-power globally, it may not be feasible or appropriate for the Government to intervene in such decisions. The Committee acknowledged the outstanding quality of Indian professionals and the high esteem and remuneration commanded by them internationally. The international practice does not impose limits on managerial remuneration. A restrictive regime based on Government approvals, apart from introducing delays may also result in best and the brightest moving away across borders in search of higher compensation.

13.5 The Committee felt that the issue of remuneration had to be decided by the shareholders in context of the circumstances of the company. To enable proper decision making in this regard, it was important to subject this aspect to proper corporate governance processes on the basis of correct disclosures. Therefore, the Committee felt that this decision need not be taken by the Government on behalf of the company but should be left to its shareholders whose approval should necessarily be taken. Such approval should take into account the recommendations of Remuneration Committee, where prescribed or in existence, through the Board.

13.6 However, what comprises remuneration should be provided for under the Rules to the Act. No quantified limits need be prescribed. Remuneration received by the directors of the holding company from subsidiary companies need not be barred but should be disclosed in the Annual Report of the holding company.

13.7 In case of inadequacy of profits (or no profits), the company should be allowed to pay remuneration as recommended by Remuneration Committee, where such Committee is prescribed or exists, through the Board and approved by shareholders.

13.8 Though the Committee has separately recommended that the issue of managerial remuneration should be determined by the shareholders only, the Committee also felt that the existing method of computation of net profits for the purpose of managerial remuneration, in the manner laid down in Sections 349 and 350 of the Act, should be done away with since the current provisions of the Companies Act adequately ensure that a true and fair picture of the company's profit is presented.

**Sitting Fees to Non-Executive Directors**

14. There need not be any limit prescribed to sitting fees payable to non-executive directors. The company, with the approval of shareholders may decide the sitting fees payable to such category of directors and should disclose it in its Directors' Remuneration Report forming part of the Annual Report of the company.

Disclosure of Remuneration

15.1 All type of companies should be required to disclose the Directors'/Managerial remuneration in the Directors' Remuneration Report as a part of the Directors' Report.

15.2 The information in the Directors' Remuneration Report may contain all elements of remuneration package of directors, including severance package and other details like company's policy on directors' remuneration for the following year, performance graph etc.

**<u>Remuneration of Non-Executive Directors</u>**

16. A company should also be able to decide on remuneration to non-executive directors including independent directors. This may be in the form of Sitting fees for Board and committee meetings attended physically or participated in electronically and / or Profit related commissions

**<u>Board Committees</u>**

17. While recognizing the need for discretion of the Board to manage and govern the company through collective responsibility, the Committee recognizes the need for focus on certain core areas relevant to investor / stakeholder interests. In such areas, law may mandate the requirement of constitution of specific Committees of the Board whose recommendations would be available to the Board while taking the final decisions. These Committees are as follows :-

**Audit Committee for Accounting and Financial matters**

17.1 The Committee recommends that :-

(a) Majority of the Directors to be independent directors if the Company is required to appoint Independent Directors;

(b) Chairman of the Committee also to be independent;

(c) At least one member of Audit Committee to have knowledge of financial management or audit or accounts;

(d) The Chairman of the Audit Committee should be required to attend the Annual General Meeting of the company to provide any clarification on matters relating to audit. If he is unable to attend due to circumstances beyond his control, any other member of the Audit Committee may be authorized by him to attend the Annual General Meeting on his behalf;

(e) The recommendation of the Audit Committee if overruled by the Board, should be disclosed in the Directors' Report along with the reasons for overruling.

**Stakeholders' Relationship Committee**

17.2 Companies having a combined shareholder/deposit holder/ debenture holder base of a thousand or more should be required to constitute a Stake Holders Relationship Committee to monitor redressal of their grievances

17.3 The Committee should be chaired by a Non-Executive director.

**Remuneration Committee**

17.4 There should be an obligation on the Board of a public listed company, or any company accepting deposits, provided as a part of substantive law, to constitute a Remuneration Committee, comprising non-executive directors including at least one Independent Director in the case of a company where Independent directors have been prescribed. In such cases, Chairman of the Committee should be an independent director. Small companies may be exempted from such a requirement.

17.5 The Remuneration Committee will determine the company's policy as well as specific remuneration packages for its managing/executive directors/senior management. The Chairman or in his absence at least one member of the Remuneration Committee should be present in the General Meeting to answer shareholders' queries.

**Duties And Responsibilities Of Directors**

18.1 International practice (particularly in U.K.) recognizes a very wide spectrum of duties to be discharged by directors of a company. There is an obligation of obedience to the constitution and decisions of the company lawfully taken under it, or under rules of law permitting such decisions to be taken, the duty of loyalty towards the company and, in good faith, to promote its success to the benefit of members as a whole, to exercise independence of judgment along with care, skill and diligence in exercise of duties, to disclose transactions involving conflict of interest and seek shareholders approval as relevant, not to exploit company assets or benefits from third parties for personal purposes, the duty of special care if a company is unable to pay its debts or is facing a likely prospect of an insolvent situation. The question is whether all such duties, and more, can be recognized in law.

18.2 The Committee is of the view that this aspect should be exposed to a thorough debate. The law may include certain duties for directors, with civil consequences to follow for non-performance. However, the law should provide only an inclusive, and not exhaustive list in view of the fact that no rule of universal application can be formulated as to the duties of the directors.

18.3 Certain basic duties should be spelt out in the Act itself such as

(a) duty of care and diligence;

(b) exercise of powers in good faith, i.e., discharge of duties in the best interest of the company, no improper use of position and information to gain an advantage for themselves or someone else;

(c) duty to have regard to the interest of the employees, etc.

**Disqualification of Directors**

19.1 The conditions for disqualification of a director should be prescribed in the Act itself as they relate to the substantive law and may not require much change once the law is framed.

19.2 Director proposed to be appointed should be required to give a declaration to the Board that he is not disqualified to be appointed as a director under provisions of the Act.

19.3 Provision of Section 274 (1) (g) of the present Companies Act, prescribing the dis-qualifications of directors, inter alia, provides that a person is disqualified for being appointed as a director in other companies for a period of five years, if such person is a director of a public company which has failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more. This disqualification should be retained.

19.4 In case of sick companies which have defaulted on payment of deposits/debentures etc., it is necessary to re-constitute its Board of Directors for the purpose of rehabilitation of such companies. The new directors who join boards of such companies are likely to attract the disqualification under the present Section 274 (1) (g) of the Companies Act. In order to encourage qualified professionals to join Boards of such companies, it is necessary to amend Section 274 (1) (g) of the Companies Act to provide that such disqualification would not be applicable for new directors joining the boards of such sick companies which have failed to repay their deposits, debentures etc.

**Vacation of office by the Directors**

20. Failure to attend Board Meetings for a continuous period of one year should be made a ground for vacation of office by the concerned director regardless of leave of absence being given by the Board for the meetings held during the year.

**Resignation Of Directors**

21.1 Resignation should be treated as a choice to be exercised by a director. In case of resignation, it should be sufficient for the director to establish proof of delivery of such information with the company to discharge him of any liability in this regard, or of events taking place subsequent to his having intimated his decision to resign. A copy of the resignation letter should also be forwarded to the ROC within a prescribed period by the Director along with proof of delivery to the company. This is necessary to avoid misuse of this choice through retroactive communications.

21.2 There should not be any requirement on the part of the company to formally accept such resignation for it to be effective. Should become effective from the date of resignation, provided the filing with the ROC is within the prescribed period.

21.3 There should be a specific duty on the part of the company to file information with ROC of a director's resignation within a prescribed period of time of its being received.

21.4 Provision should be made that if the number of directors and the additional directors fall below the minimum strength fixed for the Board under the law, due to the resignation of director(s), the remaining directors can co-opt one or more persons as additional directors.

21.5 If there is a resignation by all directors, then the promoters or persons having controlling interest should either nominate the minimum required number of directors or if they do not, they should be deemed as directors in the intervening period, till the general body of the company appoints new directors. “Controlling Interest” should be defined in law. However, in case of companies without any identifiable promoters, the law will need to specify the manner of selection of directors.

21.6 The promoters of a company should be identified by each company at the time of incorporation and in its Annual Return.

21.7 In the event of all directors vacating office, the promoters should hold office as directors till the next AGM wherein new directors should be appointed.

21.8 To prevent directors from diverting funds of companies, it is necessary to lay down some responsibility on directors who are appointed on the Boards of companies which come out with public issues. Sometimes, due to presence of celebrity directors, the general public gets attracted to invest without heed to the merits of the issue. This is particularly so when such personalities are given a ‘larger-than-life’ image by the media. The Indian public, newly exposed to capital market may easily be misled. Companies may also raise funds behind such a veneer and later on not use them for the avowed purpose. Therefore, to lay down more responsibilities on companies seeking public subscription, they should be required to preserve the composition of the Board of Directors for two years or till the procured funds are utilized in accordance with the objectives stated in the prospectus, whichever is earlier. In case the director resigns from such a company, his liability under the prospectus including utilization of funds should continue till the above period.

**Liabilities Of Independent And Non-Executive Directors**

22. A non-executive/independent director should be held liable only in respect of any contravention of any provisions of the Act which had taken place with his knowledge (attributable through Board processes) and where he has not acted diligently, or with his consent or connivance.

**Knowledge Test**

22.1 If the independent director does not initiate any action upon knowledge of any wrong, such director should be held liable.

22.2 Knowledge should flow from the processes of the Board. Additionally, upon knowledge of any wrong, follow up action / dissent of such independent directors from the commission of the wrong should be recorded in the minutes of the board meeting.

**Directors and Officers (D&O) Insurance**

23. Insurance for key-man and for key directors and officers of companies by means of general insurance policies may be taken by companies. Directors and

Officers (D&O) insurance is a means by which companies and their directors/ officers may seek to mitigate potential personal liability. Insurance aids independence as the directors are not dependent on the company. Accordingly, S. 201 of the Companies Act should be modified to have the enabling provision for providing insurance / indemnification in case no wrongful act is established. The insurance premium paid by the company for such a policy need not be treated as a perquisite or income in the hands of director. However, if the wrongful act of the director is established, then the proportionate amount of premium attributable to such director should be considered as perquisite/income for the purpose of remuneration.

**Rights of Independent/Non-Executive Directors**

24. Independent / Non-Executive directors should be able to :-

- Call upon the Board for due diligence or obtaining of record for seeking professional opinion by the Board;

- have the right to inspect records of the company;

- review legal compliance reports prepared by the company; and

- in cases of disagreement, record their dissent in the minutes.

**Meetings Of Directors- Related Matters**

25.1 The requirement of the Companies Act, 1956, to hold a meeting every three months and at-least 4 meetings in a year should continue. The gap between two Board Meetings should not exceed four months.

25.2 The Committee is of the view that law should facilitate use of technology to carry out statutory processes efficiently. Meetings of the Board of Directors by electronic means (Teleconferencing and video conferencing included) to be allowed and directors who participate through electronic means should be counted for attendance and form part of Quorum. Minutes should be approved/ accepted by such directors who attended by way of teleconferencing/ videoconferencing (Signature may be accepted by use of digital signature certification. If any director has some reservation about the contents of the Minutes, he may raise the issue in succeeding meeting and the dissent, if any, may be recorded in the minutes of that meeting.

**Quorum for emergency meetings**

26. In the case of companies where Independent Directors are prescribed :-

- Notice of every meeting of the Board of Directors should be given well in advance to ensure participation by maximum number of directors. In view of the Committee, a period of 7 days is sufficient for the purpose.

- The presence of one independent director should be made mandatory for board meetings called at short notice.

- Meetings at shorter notices should be held only to transact emergency business. In such meetings the mandatory presence of at least one Independent Director should be required since this would ensure that only well considered decisions are taken.

- If even one Independent Director is not present in the emergency meeting, then decisions taken at such meetings should be subject to ratification by at least one Independent Director.

**Matters to be discussed at a Board Meeting**

27. There is a need to ensure that the meetings of Board of Directors provide sufficient time for consideration of important matters. The Committee was of the view that there should be a clear recognition of vital issues for which Board discussion in the meeting of the Board should be mandatory. These matters should not be left to Resolution by circulation since this practice is open to abuse. The suggestions made in the Companies (Amendment) Bill, 2003 may be taken as the basis.

**Restrictions on Board's Powers**

28. Under Section 293 of the present Act certain restrictions have been placed on the Board of Directors of a public company or of a private company, which is a subsidiary of a public company from deciding on certain matters except with the consent of the shareholders of such company in a general meeting. This provision should be reviewed and it should be provided that the consent of the shareholders should be through a special resolution for certain items such as those presently mentioned in 293 (1) (a), (c) and (d) of the present Act. Shareholders' approval should be required for sale of whole or substantially whole of the undertaking in that financial year. "whole or substantially whole" should mean 20% of the total assets of the company. Further, certain additional items that should require shareholders approval may include sale/transfer of investment in equity shares of other bodies corporate which constitute 20% or more of the total assets of the investing company.

**Meetings Of Members**

29.1 Every company should be permitted to transact any item of business as it deems fit through postal ballot apart from items for which mandatory postal ballot is prescribed. However, the government should prescribe a negative list of items which should be transacted only at the AGM and not through postal ballot. These negative items could be the following items of Ordinary Business :-

(i) consideration of annual accounts and reports of Directors and Auditors;

(ii) declaration of dividends;

(iii) appointment of directors; and

(iv) appointment of and fixing the remuneration of the auditors.

29.2 Similarly, items of business in respect of which Directors/Auditors have a right to be heard at the meeting (e.g. when there is a notice for their removal), should not be transacted through voting by postal ballot.

29.3 Electronic Voting – Law should provide for an enabling clause for voting through electronic mode.

29.4 Place of Meeting - AGM may also be held at a place other than the place of its Registered Office, provided at least 10% members in number reside at such place (In India only).

**AGM in Small Companies**

30.1 Small Companies may be given an option to dispense with the requirement of holding an AGM. Such companies may be permitted to pass Resolutions by circulation.

30.2 (d) The items of negative lists as identified above, may also be transacted by Small Companies through postal ballot.

**Demand For Poll**

31.1 The demand for poll can be made by shareholder(s) holding 1/10$^{th}$ of the total voting power or shares of paid up value of Rs.5 lakhs, whichever is less.

31.2 The Committee considered a view that the Chairman of the meeting should have the discretion to overrule a demand for poll, if it can be established that a resolution with the requisite majority can be passed on the basis of representations or proxies at hand. This view has to be balanced with an appreciation of minority interests. In some cases, the powers to demand poll have been misused. The Committee is of the view that the threshold limit needs to be reviewed to enable conduct of business in an orderly yet democratic manner and the same may be prescribed by way of Rules. Alternatively, possibility of vesting the Chairman of the meeting with the power to overrule a demand for poll in certain circumstances may be provided.

**Other Recommendations**

**Higher deposit amount for notice regarding nominating/appointing a director.**

32. Presently, any person can give nomination for appointment as a director with a deposit of Rs. 500/- Such nomination should be allowed to be made only by shareholders constituting 1% of paid up capital and with a deposit of Rs. 10000/- which should be forfeited if the Director does not get elected.

**Option of buy-back for shareholders of de-listed companies**

33. To protect the shareholders of a listed company that opts to de-list, one buy-back offer by the company should be mandated within a period of 3 years of its de-listing from all the stock exchanges in India. Appropriate valuation Rules for this purpose should be prescribed.

**<u>Corporate Structure</u>**

34.1 Stakeholders / Board look towards certain Key Managerial Personnel for formulation and execution of policies and to outside independent professionals for independent assurances on various compliances. The Committee feels it desirable to dwell on such managerial personnel who have a significant role to play in the conduct of affairs of the company and determine the quality of its Governance. The Committee is of the view that such key Managerial Personnel may be recognized by the law, along with their liability in appropriate aspects of company operation.

**Key Managerial Personnel**:-

34.2 The Committee identifies the following key Managerial Personnel for all companies:-

- Chief Executive Officer (CEO)/Managing Director
- Company Secretary (CS)
- Chief Finance Officer (CFO]

<u>RECOMMENDATIONS</u> –

➢ The appointment and removal of the key managerial personnel should be by the Board of Directors.

➢ The key managerial personnel including managing / (whole time) Executive Directors should be in the whole-time employment of only one company at any given time.

➢ Both the managing director as also the whole time directors should not be appointed for more than 5 years at a time.

➢ As provided currently, the option to a company to appoint director by proportional representation may be retained.

➢ The present requirement of having managing director/whole time director in a pubic company with a paid up capital of Rs.5 crores may be revised to Rs.10 crores by appropriate amendment of the Rules. The said limit could be reviewed from time to time.

Special exemptions may be provided for small companies from appointing such personnel on whole-time basis. Such companies may obtain services that may be considered mandatory under law from qualified professionals in practice.

**<u>Interested Shareholders</u>**

35. The Committee considered the concept of exclusion of interested shareholders from participation in the General Meeting in events of conflict of interest. The Committee felt that this was an aspect of good Corporate Governance which may be adopted by companies on voluntary basis by making a provision in the Article of

Association of the company. In view of the issues related with enforcing compliance of such requirements, there need not be any specific legal provision for the purpose.

**General**

36.1 Sometimes, board appointees include persons who clearly lack the experience or the capacity to function as directors. Low-level employees or un-experienced relatives of shareholders also sometimes find their way into the boards, with 'shadow' directors pulling strings and acting as real decision makers. The law should provide for a framework that allows attribution by recognizing the presence of any person in accordance with whose directions or instructions, the directors of the company are accustomed to act. There should also be a requirement of disclosure of directors background, education, training and qualifications, as well as relationships with managers and shareholders.

36.2 The Committee recognizes that to enable all companies to access good quality managerial talent, efforts by various institutions, organizations and associations to train directors should be encouraged. An important role can be played in this respect by professional bodies, chambers of commerce, trade associations, business and law schools. Such efforts, while upgrading the skills of directors would also expand the pool of candidates from which such candidates may be selected. Such efforts should aim at better discharge of fiduciary duties and value enhancing board activities. There should be specific executive development programmes aimed at developing the awareness levels of Board level appointees. Such persons should also be provided an insight into corporate law compliance requirements.

36.3 It is to recognize that law cannot specify corporate governance in its entirety. There are several behavioural norms that cannot be addressed through a legal framework. There is, therefore, space for Corporate Governance Codes to supplement and strengthen the legal provisions. There should be an interactive dialogue between professional bodies and corporate sector to enable evolution of such Codes.

36.4 Voluntary or Comply-and-Explain codes of conduct for directors should be developed and disseminated by private sector and professional organizations. Such codes should detail the minimum procedures and care that make up due diligence and care. The presence of such codes would serve to educate both directors and investing public.

36.5 The corporates should be encouraged to seek independent assessment/audit of the conduct of polls during general meetings of the company.

36.6 Punishments for violation of fiduciary duties should be sufficiently severe so as to deter wrongdoing.

## **Chapter V : Related Party Transactions**

1. While directors have the authority to regulate the affairs of the company collectively as Board, their duties of good faith and fair dealings are owed by each director individually. Directors have the duty not to place themselves in a position when their fiduciary duties towards the company conflict with their personal interests. And in case it happens, directors have the duty to prefer interests of the company. Directors should not use company's assets, opportunities or information for their own profit.

2. The Committee deliberated on whether transactions/contracts in which directors or their relatives are interested should be regulated through a "Government Approval-based regime" or through a "Shareholder Approval and Disclosure-based regime". The committee looked into international practices in this regard and felt that the latter approach would be appropriate in the future Indian context.

### **Director's duty to disclose interest**

3.1 The Law should impose a duty on every director to disclose to the company, the contracts or arrangements with the company, whether existing or proposed or acquired subsequently, in which he, directly or indirectly, has any interest or concern.

3.2 The manner, time limit and the extent of such disclosure should be specified in the Act. The notice for relevant disclosure should be made by the interested director to the Board of Directors at a meeting of the Board in which the transaction is to be discussed, so that information is available to the Board in a timely manner. The provisions in the existing Law to issue general notice by the directors in respect of their interest in contracts/arrangements by the company should continue.

3.3 Failure to make disclosure should be treated as a default. Director concerned should be held liable to penalties and he should be deemed to have vacated his office. This should also be a condition of disqualification to hold office of director of that company for a prescribed period.

3.4 Directors' Responsibility Statement should include an additional clause to the effect that every director has made relevant disclosures as mentioned above.

3.5 Interested director should abstain from participating in the Board meeting during consideration of relevant agenda item in which he is interested.

3.6 The company should maintain a register, in which all transactions above a prescribed threshold value in respect of contracts/arrangements, in which directors are interested, should be entered. The register should be kept at registered office of the company and should be open to inspection to all members.

**Certain transactions, in which directors are interested, to take place only subject to approval of Board/shareholders**

4.1 In addition to disclosure requirements in respect of all transactions/contracts/arrangements in which directors are interested, certain transactions, between company and director or persons connected with director, in respect of sale, purchase of goods, materials or services should take place only with the approval of Board of Directors. A threshold limit may be fixed under the Rules in respect of powers of the Board in this regard.

4.2 Beyond a limit, the approval of shareholders, by special resolution, should be mandated. The particulars/details pertaining to such contracts/arrangements to be included in the explanatory statement (to relevant special resolution), to be sent to shareholders, should be specified in the rules.

4.3 Similar provisions should be applicable in respect of all transactions relating to transfer or lease of immovable property to/by the interested director by/to the company.

4.4 The existing exemption under Section 297 (2) (a) of the Companies Act in relation to transaction/contract/arrangement taking place for cash at market price should continue.

**Disclosures**

4.5 Details of Transactions of the Company with its Holding or Subsidiary / Fellow Subsidiary or Associate Companies in the ordinary course of business and transacted on an arms length basis should be placed periodically before the Board through the Audit Committee, if any.

4.6 Details of transactions not in a normal course of business and / or not on an arms length basis with Holding/Subsidiary/Fellow Subsidiary/Associate Companies should be placed before the Board together with Management justification for the same. A summary of such transactions with each party should form part of the Annual Report of the Company.

4.7 Non compliance of these provisions should result into:-

(a) Penalty on director who authorized transaction/contract etc. without approval of Board/General meeting.

(b) Transaction/Contract being voidable at the option of the Board/Company.

(c) Director concerned to account to the company for any gain made by him and to indemnify the company against wrongful gain made at the cost of the company.

(d) The Director concerned being deemed to have vacated his office.

(e) Disqualification of the director to hold office in the company for a prescribed period.

**Restrictions on Loan to director or holding office or place of profit by relative of director**

5.1 Generally the directors should not be encouraged to avail of loans or guarantees from companies. They should be allowed remuneration or sitting fees only. In case company decides so, loans to directors should be allowed only when company by special resolution approves such loans. Disclosures to be made to shareholders, through the explanatory statement, should be specified in the rules. It should be open to a company to formulate schemes (such as Housing Loan Schemes) for the benefit of Executive Directors. Once such schemes are approved by the shareholders by special resolution, loans under such schemes may be allowed to eligible directors, without again going to shareholders for approval.

5.2 Transactions relating to short term Quasi-Loans to director or funding of director's expenditure (to be reimbursed by director later on) up to a specified limit (by rules) may be allowed subject to approval by the shareholders through special resolution.

[Quasi loan is a transaction where one party - the creditor agrees to pay or pays otherwise than in pursuance of an agreement, a sum for another (the borrower) or agrees to reimburse, or reimburses otherwise than in pursuance of an agreement expenditure incurred by a third party for the borrower on terms that the borrower would reimburse the creditor or in circumstances that give rise to a liability for the borrower to reimburse creditor.]

5.3 Funding of Director's legitimate expenditure on duty to the company should be excluded from these regulations.

5.4 Special provisions may be made for loans or quasi loans by money lending companies to its employee including directors to be allowed, subject to regulations of RBI and other regulators.

5.5 The director or relatives of a director should be allowed to hold office or place of profit in the company upto a limit (to be specified by rules) only if shareholders, by special resolution, approve. (The office of MD or WTD should not be treated as office or place of profit.)

**Duty on directors to disclose information relating to directorship and shareholdings in the company and in other companies**

6.1 Every director should be under obligation to disclose to the company:-

(i) Personal details as may be prescribed by way of rules.

(ii) Directorships (including Managing Directorship, Whole Time-Directorship or Managership) held by him in any other company/firm.

(iii) Shares or debentures held by him as well as his relative in the company and all other companies, as referred to in para 4.5 above.

(iv) Names of Companies in which director either singly or along with his relatives hold not less than a specified percentage of shareholding as may be specified by Law.

(v) Names of other entities in which he is directly or indirectly interested as partner, member or a key person, by whatever name called.

(vi) Any changes in respect of above items [(i) to (v)] to the company should be informed within a time specified by Law.

6.2 Non disclosure of above information by any director should hold such director liable to pay fine.

6.3 The company should keep a register containing relevant details mentioned in para 6.1 in respect of each director. Register should be open for inspection by all members of the company.

## Chapter VI : Minority Interests

**Balance to be struck between the rule of the majority and the rights of the minority**

1. The fundamental principle defining operation of shareholders democracy is that the rule of majority shall prevail. However, it is also necessary to ensure that this power of the majority is placed within reasonable bounds and does not result in oppression of the minority and mis-management of the company. The minority interests, therefore, have to be given a voice to make their opinions known at the decision making levels. The law should provide for such a mechanism. If necessary, in cases where minority has been unfairly treated in violation of the law, the avenue to approach an appropriate body for protecting their interests and those of the company should be provided for. The law must balance the need for effective decision making on corporate matters on the basis of consensus without permitting persons in control of the company, i.e., the majority, to stifle action for redressal arising out of their own wrong doing.

**Minority and 'Minority Interest' should be specified in the substantive Law**

2.1 At present, in case of a company having share capital, not less than 100 members or not less than $1/10^{th}$ of total number of members, whichever is less or any member or members holding not less than $1/10^{th}$ of issued share capital have the right to apply to CLB/NCLT in case of oppression and mismanagement. In case of companies not having share capital, not less than $1/5^{th}$ of total number of members have the right to apply.

2.2 To reflect the interest of the "Minority", a 10% criteria in case of companies having share capital and a 20% criteria in the case of other companies is provided for in the existing Act. In Section 395 of the Act, the dissenting shareholders have been put at the limit of 10% of shares. Thus Minority could be defined as holding not more than 10% shares for the limited purpose of agitating their rights before the appropriate forum.

2.3 Oppression is defined in section 397(2). It is defined as conducting the company's affairs in a manner prejudicial to public interest or in a manner oppressive to any member or members. Mis-management has been defined in section 398(1) of the Act, as conducting the affairs of the company in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company.

2.4 The Committee on examination of the existing provisions felt that a reasonable framework could be enabled through specific provisions to be brought in the new Act to define "Minority" (on the lines of clause (2.2) above) and the "Minority Interest " (on the lines of clause (2.3) above).

**Representation of minority interests**

3. While the Committee feels that the concept of independent directors would provide an objective scrutiny of management, operations and decision making, the Boards of the companies could also incorporate the concept of representation of specific minority shareholders group. It was observed that the existing Act provided an option to company to adopt proportionate representation for the appointment of directors but this option was rarely used. A view was expressed that the applicability of the provisions of Section 265 (existing Act) could be made mandatory. The specific minority appointed director/independent director could also play an important role in investor protection. The Committee view was that the existing option may be retained.

**Right of share holders to be informed through correct disclosures**

4. The risks of investors can be reduced / minimized through adequate transparency and disclosures. The law should indicate in clear terms the rights of members of the company to get all information to which they are entitled in a timely manner. The financial information and disclosures to be provided to shareholders should not be in excessively technical format but should be simple to understand. This will enhance the credibility of the company and will help the shareholders to take an informed and conscious decision in respect of their investments. Besides, statutory information, which would be regulated through law, the information could also be made available through other means like print, electronic media, company website etc. A regime of stringent disclosure norms should be provided for in case of companies accessing funds through public offers. There should be adequate and deterrent penalties in law against wrong disclosures.

**Right of minority to be heard**

5. Once the principle of protection of “Minority Interest” is recognized in the Act, there would also be a need to put in place an appropriate mechanism for ensuring that such provisions relating to “Minority Interest” do not obstruct the Board or the management from performing their functions genuinely in interests of the company. The Board and the management should, therefore, be protected from undue and unjustified interference from unscrupulous shareholders acting in the guise of investors’ rights.

**Rights of minority shareholders during meetings of the company**

6. Sometimes, the meetings of the company are so organized so as to deprive the minority of an effective hearing. The procedures to be prescribed under the Act should safeguard against such behaviour by the company. There should be extensive use of postal ballot including electronic media to enable shareholders to participate in meetings.

**Rights in case of Oppression and Mismanagement**

7. There are adequate provisions in the existing Act to prevent Oppression and Mismanagement. Minority, represented by specified number of members or members holding requisite percentage of equity capital are entitled to approach Courts/Tribunals for protection of their interests. The quasi-judicial body is

empowered to order a number of remedial measures for regulation of the conduct of company's affairs. These measures, inter-alia, include purchase of shares or interests of any members of company by other members; termination, setting aside or modification of agreements relating to managerial personnel; setting aside of transactions relating to transfer, delivery of goods etc, or any other matter for which Court/Tribunal feels that provisions should be made. The Court/Tribunal is also empowered to appoint such number of persons as necessary to effectively safeguard interest of the company.

**Rights of minority shareholders during mergers/ amalgamations/ takeovers**

8.1 As per existing provisions of the Act, approval of High Court / Tribunal is required in case of corporate restructuring (which, inter-alia, includes, mergers/amalgamations etc.) by a company. The Scheme is also required to be approved by shareholders, before it is filed with the High Court. The scheme is circulated to all shareholders along with statutory notice of the court convened meeting and the explanatory statement u/s 393 of the Act for approving the scheme by shareholders.

8.2 Though there may not be any protection to any dissenting minority shareholders on this issue, the Courts, while approving the scheme, follow judicious approach by mandating publicity about the proposed scheme in newspaper to seek objections, if any, against the scheme from the shareholders. Any interested person (including a minority shareholder) may appear before the Court. There have been, however, occasions when shareholders holding miniscule shareholdings, have made frivolous objections against the scheme, just with the objective of stalling or deferring the implementation of the scheme. The courts have, on a number of occasions, overruled their objections.

8.3 It is, therefore, felt that there should be specific provision in the Act to put a limit (either according to a minimum number of persons or according to a minimum percentage of shareholding) for entitling any body to object such a scheme. It would also be appropriate to provide for acquisition of remaining 10% shares in a company, of which 90% has been acquired by an acquirer. Such acquisition of 10% shares should be as per Rules to be framed by Central Government. The Committee has also made recommendations separately in para 19 of Chapter X, concerning a threshold limit for maintainability of objections by barring minority shareholders with insignificant stake from obstructing schemes of arrangement.

8.4 In case of Takeovers, as per SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997, SEBI has powers to appoint investigating officer to undertake investigation, in case complaints are received from the investors, intermediaries or any other person on any matter having a bearing on the allegations of substantial acquisition of shares and takeovers. SEBI may also carry out such investigation suo moto upon its own knowledge or information about any breach of these regulations. Under section 395 of the Act, a transferee company, which has acquired 90% shares of a transferor company through a scheme or contract, is entitled to acquire shares of remaining 10% shareholders. Dissenting shareholders have been provided with an opportunity to approach Court/Tribunal. This scheme of things appears to be fair and should be continued.

**In sum :-**

a) In order to object a scheme of amalgamation by investors, a limit shall be determined either according to the minimum number of members or according to the minimum percentage of shareholding;

b) The provision of section 395A which were incorporated in the Companies (Amendment) Bill, 2003 for acquisition of remaining shares may be considered as a basis for developing an appropriate framework in this regard.

**Fair valuation as a means of safeguarding minority interests**

9.1 There should be recognition of principle of valuation of shares of a company through an independent valuation mechanism as means of safeguarding minority interests. The independent valuer should be appointed by Audit Committee where such a Committee is mandated or by the Board in other cases. The shareholders should have the right to approach the Court / Tribunal if they perceive the process to be unfair. In such cases, the Tribunal should be empowered to appoint an independent valuer. These principles for valuation of shares could also applied in case of companies that have delisted and have a shareholder base of 1000 or more.

9.2 Further, this Committee has recommended that a company that has delisted from all the Stock Exchanges in India and has a shareholder / depositor base of 1000 or more should be mandated to give one buy-back offer within a period of three years of delisting. The Committee feels that such an offer, taken in the background of the recommendations of ensuring fair valuations of shares, would also serve to protect minority interests.

**Class Action/Derivative suits**

10.1 In case of fraud on the minority by wrongdoers, who are in control and prevent the company itself bringing an action in its own name, derivative actions in respect of such wrong non-ratifiable decisions, have been allowed by courts. Such derivative actions are brought out by shareholder(s) on behalf of the company, and not in their personal capacity (ies), in respect of wrong done to the company. Similarly the principle of "Class/Representative Action" by one shareholder on behalf of one or more of the shareholders of the same kind have been allowed by courts on the grounds of persons having same locus standi.

10.2 Though these principles have been upheld by courts on many occasions, these are yet to be reflected in Law. The Committee expresses the need for recognition of these principles.

## Chapter VII : Investor Education and Protection

1. The Committee noted that the growth in the numbers of investors in India was encouraging. The trends revealed that in addition to FIIs and Institutional Investors, small investors were also gradually beginning to regain the confidence in the capital markets that had been shaken consequent to the stock market scams during the past decade. It is imperative for the healthy growth of the corporate sector that this confidence is maintained. For this purpose, the Committee feels that not only should corporate systems and processes be credible and transparent, the interests of the investors may be safeguarded in a manner that enables them to exercise their choice in an informed manner while making investment decisions, and also providing them with a fair exit option.

2. The concept of investor protection has to be looked at from different angles taking into account the requirements of various kinds of investors i.e. (i) investors in equity (ii) large institutional investors (iii) Foreign Investors (iv) investors in debentures and (v) small investors/deposit holders etc. The Committee also noted the initiatives taken by the Central Government for investor education and protection. Some State Governments have also taken initiatives through legislation for protection of depositors.

### Separate Law for Investor Protection?

3. The question as to whether a separate Act is required for protection of investors was examined. After detailed discussion, the Committee formed the view that it was essential to ensure safeguarding the interest of investors through proper articulation of corporate governance in a manner that ensures transparency and accountability. The concept of investor protection cannot be treated in isolation from all the corporate processes. As such a framework exists in the country to deal with criminal offences the requirement is to provide a suitable orientation to corporate law so that the investor, irrespective of size, is recognized as a stakeholder in the corporate processes. Besides, a separate Act would require special enforcement mechanism with attendant coordination issues. Therefore, a separate Act for investor protection is not considered necessary. This aspect may be dealt with comprehensively and effectively in the Company Law itself.

### Role of Regulators

4. The interface between the companies and its stakeholders including investors should be regulated through the legislative framework of the Companies Act and other civil and criminal laws of the country as well as by different regulators such as SEBI, RBI, etc. as well as institutions such as the Stock Exchanges through their rules of operation. Sometimes, various agencies pursue action in their respective domain without regard to the comprehensive picture. This results in overlap of jurisdiction or

regulatory gaps. There is a need to bring about coordination in the role and action of various regulatory agencies to enable effective investor protection.

5. In particular, the capital market regulator, SEBI has a significant role to play in safeguarding the interest of investors. The Committee feels that such a role could be played by the regulator discharging its functions in a rational and objective manner with due regard to the interests, rights and obligations of all the stakeholders. SEBI has done a commendable job in developing the framework for Indian capital market in its formative stages subsequent to the liberalization process initiated in the 1990s. However, there is a need for the framework to develop further in a balanced manner keeping in view the Indian context while enabling best international practices. In doing so, the regulator must examine different aspects of capital market operation and the roles played by different intermediaries as also the interaction amongst them so that the capital market is able to deliver finance to meet requirements of the corporate sector promptly, in a cost effective manner and in keeping with the changing requirements of new business models. In carrying out this function, it should ensure the credibility of its processes in the eyes of the investors. Much remains to be done to achieve this objective.

**End use of Funds**

6. The Committee discussed the need for regulators to monitor the end use of funds collected from the public. The Committee felt that this should be the responsibility of the shareholders of the company who should charge company management with the responsibility coupled with adequate authority to ensure prudent and proper use of funds collected from the public. In doing so however, there is need for transparency so that both the regulators, investigative agencies as well as the investor are able to access appropriate financial information to form an opinion as to the financial conduct and performance of the company. Therefore, there should be a proper regime of disclosures in the public domain so that various agencies are able to reach their conclusion in a non-intrusive manner. Private companies could devise their own mechanism to the satisfaction of shareholders and lending institutions.

**Credit Rating**

7. The Committee examined the utility of credit rating to enable protection of investor interests. It was felt that while credit rating could only provide indicative information for the investor to assess the general standing of the company, credit rating was not an infallible assessment of the company. An impression, therefore, should not be created that sole reliance can be placed on credit ratings for investment decisions. However, credit rating would be a good evaluation mechanism and its wide use would be generally beneficial. There is however, no need to mandate credit rating by law except for companies accepting public deposits.

**Special Provisions for Depositors**

**Risk cover for depositors**

8.1 The Committee deliberated on the need for companies to take risk cover/insurance for depositors. It was felt that while risk cover may not be possible for equity investors, the insurance option should be explored for deposits with companies. It was felt that while the Banking companies and NBFCs were regulated by the RBI in the interest of the depositors, there was no similar mechanism in the case of deposits with other types of companies. Depositors, being in the nature of unsecured creditors, also do not get adequate protection under law in the event of liquidation or winding up of the company. It was also not feasible to develop a separate regulatory mechanism for this modality of mobilizing finance. However, some protection would be available to the depositors if the companies seeking deposits were also compelled to obtain insurance coverage for deposits. The Committee felt that this was a mechanism which would compel scrutiny into the credit-worthiness of the companies by the insurance companies in the interest of the depositors and hence recommend the same.

**Other provisions**

8.2 The Committee, during its deliberations discussed various aspects through which protection could be offered to safeguard the interests of depositors and made suggestions while considering the relevant corporate operations. The Committee, however, felt that the following aspects need to be brought out in a consolidated manner as follows :-

**Companies accepting public deposits should be required to**

- appoint independent directors;
- appoint audit / remuneration / stakeholders relationship committees;
- under take deposit insurance;
- undertake credit rating;
- create adequate cash reserves being set aside for repayment of deposits as may be prescribed by the rules;
- be subjected to close monitoring in respect of implementation of any scheme for repayment of deposits that may be sanctioned by CLB/Tribunal/Court;
- be subjected to a stringent disclosure regime; and
- be subjected to stringent penalties for irresponsible / fraudulent behaviour by the companies.

**Compensation to Investors**

9. The Committee also discussed issues relating to compensation to investors. It was felt that the capital market included investment into risk bearing instruments. In such cases, the investor was required to make his own assessment of risk and reward. No compensation could be visualized for such investors whose investments were in risk bearing instruments. Similarly, investment in a fixed return instrument necessitated a careful review of the borrowing entity. Such actions would also be subjected to known or declared risks. Besides, the capital market also provides an opportunity for an investor to exit. The need therefore, is to ensure proper and healthy market operation so that investors could exercise their exit options in a reasonable and equitable environment. However, there may be situations where such a frame work is distorted through frauds. There may be provisions for compensation in the event of fraud by companies being established in securing funds from investors. For this purpose lifting of corporate veil may be enabled by the law. Certain pre-emptive measures may also be incorporated in the law so that the ill-gotten gains acquired through cheating of investors can be accessed and disgorged. The Committee, therefore, feels that compensation to investors may be payable only in cases of established fraud, through a judicial process from the assets of the company or by lifting the corporate veil, those of the promoters or other beneficiaries of such fraud, accessed through a process of disgorgement.

## Investor Grievance Redressal

10. The Committee also took the views of the investor activists into account during its deliberations. The Committee noted that the phenomenon of vanishing companies had undermined investor confidence. Concerns about some of the practices followed by the depository participants to the detriment of small shareholders were also noted. An effective investor grievance redressal mechanism at the corporate level could ensure protection of the interest of investors through timely interventions. The Committee recommends that Stakeholders Relationship Committee should be mandatory for a company having a combined shareholder/deposit holder/debenture holder base of 1000 or more.

## Consumer courts / Capital Market Ombudsman

11.1 Since shares and securities are also legally deemed to be “goods” under the Consumer Protection Act, 1986, investors should have the option to approach Consumer Courts under the Consumer Protection Act as a forum to redress their complaints. The extent to which the jurisdiction of the Consumer Courts may apply in such cases would have to be defined with regard to the nature of the investment and the entitlements arising from the related transaction. The capacity of the consumer courts to adjudicate on such matters will have to be upgraded through capacity building and training of judicial officers manning such courts. Training institutes may be set up by Government/Capital market Regulator to provide such training.

11.2 With the increase in the number of investors and greater awareness on their part, timely and simplified institutional structure for dispute resolution is desirable so that the investors are not compelled to resort to costly legal proceedings for protection of their rights. This would be particular relevant for the small investors. In this context, the institution of Ombudsman for Capital Market set up by SEBI should also be strengthened.

## Investor Education and Protection Fund

12.1 The Government has established an Investor Education and Protection Fund (IEPF) under Sec. 205 C of the Companies Act, 1956 under which unclaimed funds on account of dividends, matured deposits, matured debentures, share application money etc. are transferred through the IEPF to the Government by the company on completion of seven years. The Government is required to utilize this amount through an Investor Education and Protection Fund. For this purpose, the proceeds from the companies are credited to the Consolidated Fund of India through this fund. This constitutes a cumbersome mechanism and has to be carefully examined in context of the rights of holders of securities and the role of the Government in protecting them while providing resources for investor education.

12.2 The Committee recognizes a need for ensuring the expropriated amounts to be credited back to the IEPF in their entirety. It would be desirable if this is enabled through a direct transfer of unclaimed amounts directly to a separate statutory fund under the control, supervision and management of an Administrator, without routing it through Consolidated Fund of India. The Government should also provide funds to augment the corpus of the fund through grants which may be properly deployed and managed. Returns from such a Fund should be available to be utilized for a comprehensive programme of education of small investors. The Fund may then be entrusted with full fledged responsibility to carry out activities for education of investors and protection of their rights.

12.3 The Committee also discussed various means by which funds already available under the IEPF could be utilized more effectively. It noted that the Ministry of Company Affairs, who administer the Fund, had already initiated some schemes in this regard. The Committee recommended that the structure and administration of the Fund should be revamped as above and schemes should be made more comprehensive and their scope expanded to enable flow of correct information to the investors as well as their education in respect of their rights. Such programmes should have special components for education at school/college level, on line and distance learning, support genuine efforts in the Non-Governmental sector, information collection, research and analysis on matters of small investor concerns, enable capacity building of adjudicators such as Consumer Courts on issues involved in legal redressal of investor complaints.

## State expropriation of dividend

13. The mechanism of expropriating certain unclaimed amounts due to the investors for transfer to the IEPF as provided in the present law also raises a basic

issue as to the right of the State to expropriate such proceeds when the underlying instrument or security is still in the hands of the investor who has not been able to claim it for any reason. The Committee remained unconvinced as to how the rights of the claimant holding a particular instrument could be extinguished in such cases. In view of the Committee, law should enable investors to claim returns on the securities as long as such instruments are held by them. Court ordered refunds should also be made from the funds available with IEPF. For this purpose, there should be suitable amendment in the law. It goes without saying that the procedure for making claims also needs to be simplified to facilitate reimbursement of such claims speedily. There was, therefore, a need to review the existing provisions of Section 205 C of the Companies Act and payment of unpaid dividend to the legitimate claimants, irrespective of the lapse of time.

## Role of NGOs in Investors education

14. Many problems relating to investors, particularly, small investors, can be tackled by educating the investors. Small investors should be encouraged to either invest through Mutual Fund mechanisms, or should take investment decisions only after getting adequate information about risks and rewards. The investors should also be encouraged to participate in the proceedings at general meetings (either physically or through postal ballot, including by electronic media) in a constructive manner. This requires improving the general awareness of the investors through informal mechanisms. The help of various NGOs engaged in investor protection activities should also be taken for this purpose. The Committee perceives a positive role for Investors' Associations / NGOs in this regard which should be supported by both the Government as well as corporate entities.

## Class Action / Derivative Suits

15. A situation may arise whereby the interest of the company may need to be protected from the actions of the persons in control of the company. At the same time, the interests of the larger body of investors/shareholders may have to be provided legal avenues to protect the company in their interest. For this purpose, the law should provide for 'class action/derivative suits on behalf of depositors/shareholders. The promoters, managers held guilty of misfeasance / fraud should be asked to pay the legal costs, if proven guilty. This concept has been considered by the Committee while examining issues relating to minority rights. The Committee feels that similar principles would also be relevant for investor protection and recommends the same.

## Disclosures and Investor Protection

16.1 The Committee is of the view that proper and timely disclosures are central to safeguarding investor interests. The law should ensure a disclosure regime that compels companies to disclose material information on a continuous, timely and equitable basis. Information should be disclosed when it is still relevant to the market. The companies should, therefore, be made to disclose routine information on a periodic basis and price sensitive information on a continuous basis. Capital market regulator and stock exchanges have a significant role to play in ensuring that such information is accessible by all market participants rather than a few select market players.

16.2 Use of modern technology, internet, computers, should be enabled to enhance the efficiency of the disclosure process. It should be possible to submit and disseminate financial and non-financial information by electronic means.

16.3 Law should also provide a regime for enforcement of standards for accounting, audit and non-financial disclosure through setting of such standards and their effective monitoring and enforcement. At the same time, the Government should ensure the professional independence of standard setters, transparency of their activities and adequate means of disciplining defaulters.

16.4 There should be a regime of stringent penalties, both civil and criminal for default in disclosure.

## Chapter VIII : Access to Capital

1. Capital is essential for a business to conduct its operations and to grow. In a competitive and fast changing business environment, it is critical for business to raise capital of the right amount, in the right form, at the right time and at the right price. There is a need, therefore, for flexibility to manage capital dynamically and to enable reallocation of capital between businesses. In order to enable speedier access to capital and enable effective capital management, there is a need to enable use of a wide array of capital instruments in the backdrop of streamlined statutory and regulatory framework. Such a framework should allow greater flexibility for issuers meeting defined criteria and allow a functioning market for acquisition of corporate control.

2. However matters relating to management and maintenance of capital are equally important. The law should, therefore, address ownership rights effectively by enabling proper registration of ownership, transfer of shares, exercise of voting rights, equitable sharing in the profits of the company and participation in decision making on the basis of reporting requirements that enable transparency of financial operations by the corporates. At the same time, it should facilitate disclosure of actual control structures and prohibition of insider trading as well as management entrenchment. We feel that international best practices should be adapted to the Indian situation while enabling a framework that ensures credibility of corporate operations in the minds of the stakeholders.

### Regulation of Financial Services

3. In some countries, separate enactment has been brought about to regulate certain aspects pertaining to financial aspects of corporate operation, such as the Financial Services Act, 1986 of the UK. The objective of such legislation could be discerned as consolidation of various provisions relating to securities, standardization of rules concerning civil and criminal liability for omissions and mis-statements in offer documents as also bringing the content of all such documents within a single set of legal provisions. The purpose was to enable the Government to set out the procedural aspects and the information disclosures to be provided in the form of regulations and to provide a mechanism of keeping this up to date through secondary legislation. In India, this framework is provided through the Companies Act, 1956, the Securities Contract (Regulation) Act (SCRA) and the SEBI Act. It is not desirable to add to legislative complexity and coordination issues by adding yet another enactment to the list. Therefore, as the Government takes up suitable revisions of Companies Act, 1956, we do not find any pressing requirement for a separate Financial Services Act.

### Streamlining regulatory framework

4. There is however a case for harmonization of operation of various Government entities in the financial aspects of corporate operation. We feel that a re-orientation of the Companies Act itself can enable this. While it would be essential to provide legislative basis for the core governance principles relating to maintenance and management of capital by the corporate keeping in view the interests of the shareholders and creditors, the processes in the public domain subsequent to a company making a public issue of capital are complex and require to be regulated in context of the ever changing and growing capital market. The capital market regulator has a significant role to play in this regard. Therefore there is no need for the Companies Act to go into such procedural details apart from prescriptions that enable proper administration of the Companies Act. Instead the Companies Act should have enabling provisions that allow such procedural aspects to be taken into account as prescribed by the capital market regulator. It should be possible to enable such harmony of the statute with pronouncements made by regulators or stock exchanges through their regulations/listing agreements by requiring that such regulations be read with references in them to the provisions in the Companies Act.

5. The Committee is of the view that the basic framework for governance issues relating to maintenance and management of capital, the rights flowing from ownership of such capital and regulation of various stakeholders in a corporate entity with regard to capital should be addressed in the Companies Act. However, the capital market regulator has an important role to play in regulating the role of the corporate issuers and the investors as well as that of the financial intermediaries, once a corporate enters the capital market. While there is no requirement for the capital markets regulator to go into internal governance processes of the corporate, matters which are within regulation making powers of such regulator, need not be subsumed within the rule making powers under the Company Law. The regulator should assess the liability of the corporate in terms of the commitments made by it in the public domain while seeking investors' participation. The legal framework should provide a mechanism for dove-tailing of the substantive provisions of the law with the detailed regulations which may be issued by the market regulator.

6. All the instruments of State intervention, the Ministry of the Government or the Regulator constituted by the Government under any statutory instrument fall within the Government domain. It is necessary for the Government to enable necessary coordination in the matter. The presence of the Regulator does not also mean that the State is absolved of all responsibility in that particular domain. The experience in the capital markets in the 1990s, which witnessed two major stock market scams are a case in point. The recommendations of the Joint Parliamentary Committee also highlight the need for effective coordination in this regard.

7. We feel that the regulatory gaps cannot be plugged by carving out of domain. Rather, in a fluid and complex situation this may create further gaps that may be exploited by unscrupulous elements. Instead such gaps are to be dealt with by harmonious interpretation and mutual capacity building by the Government and its Regulatory agencies. At the same time, respective enactments clearly specify the jurisdiction of each agency. There is no requirement for providing for concurrent jurisdiction since such arrangements result in confusion in terms of action to be taken by each. Therefore, the Committee recommends that simultaneous to the harmonious regulatory approach providing for space to each regulator to operate effectively in their domain, provisions in the Companies Act allowing multiple jurisdictions may be done

away with. The Committee is of the view that this approach would not restrict the functioning of the capital market regulator in any manner but would focus its efforts more meaningfully on capital market issues. Further, the Committee is of the view that the regulatory approach should not result in an intrusive system of controls or revert back to the regime administered by the Controller of Capital Issues that existed prior to the establishment of SEBI.

8. We are also of the view that there is a need for different agencies to interact with each other more comprehensively in operational matters to enable such coordination. Interaction between SEBI and MCA need not be limited to Central Monitoring Committee on Vanishing Companies or representation on the SEBI Board, but may be augmented further through institutional mechanisms that enable consultation on various issues on a regular basis. This will enable the Government to present a common framework to the corporate sector, thereby resolving regulatory uncertainty.

**Simplifying approval requirements**

9. It is felt that at present there are multiple approval requirements for raising capital by companies. Such companies have to expend time and energy in obtaining approvals and completing the administrative processes involved. It is recognized that issue of capital by various classes of companies may have to be overseen by the concerned regulator such as SEBI (in the case of listed companies) or the RBI (in the case of Banking and NBFCs). In such cases, oversight by such Regulators is also essential. However, this process should be made time bound with introduction of the concept of deemed approval. This should equally apply to administrative processes such as the filing and registration of documents with the ROCs.

10. It is also felt that various time limits prescribed in the Act for various steps involved in raising of capital should be rationalized and reduced wherever possible. The communication channels available to the corporates for the purpose of dissemination of information should also be augmented by allowing use of electronic media in the process of issue of capital.

To sum up :-

(a) Basic framework and provisions relating to issue and management of capital, rights flowing from ownership of capital and regulation of various stakeholders with regard to capital should be addressed in the Companies Act.

(b) Capital market regulator should work out the details through regulations governing the operation of the capital market. There should be suitable dove-tailing between substantive provisions of the Act and the regulations of the Capital Market Regulator.

(c) Timeframe prescribed under law for process of issue of capital should be rationalized and reduced. It should be brought at par with international practices.

(d) The processes on the part of regulators and other administrative bodies should be made time bound with the introduction of the concept of Deemed Approval.

(e) Corporate issuers of capital should also be allowed to use electronic media in the process of issue of capital.

## Costs of raising capital- Shelf Prospectus

11. The issue of capital through release of a prospectus involves various processes that are time consuming and costly. Such processes also have to be repeated if the corporate requires to access capital again. It should be possible to avoid such costs. Presently the Companies Act recognizes the concept of Shelf Prospectus which is applicable for a period of time which is specified in the Act. At the time of subsequent issue only specified material changes need to be indicated. This concept may be extended to classes of companies as may be recommended by the capital market regulator from time to time, through issue of notification under the Act. It is advisable that suitable criteria for identifying such companies that may be acknowledged as Well Known Seasoned Issuers (WKSI), may be evolved by SEBI through regulation in respect of corporates which raise capital more frequently. Such corporates may be allowed to provide a Main Document in a year and thereafter only incremental changes should be reportable by them every time they access the market during the currency of shelf-prospectus.

## Rights Issues

12. At present making a Rights Issue takes three months to be completed thus imposing a delay in the company accessing the funds raised through issue of rights. This process should be reviewed in comparison with international practices so that the process in the Indian context can be completed in a comparable time, keeping in view the requirement to afford a reasonable opportunity to the investors to exercise the right in Indian context. It may be possible to take up some of the activities simultaneously.

## Deemed public offering

13. At present an offering made to 50 or more persons is deemed to be a Public Offer. Exemption is available from this requirement to NBFCs and PFIs. There is a rationale for providing exemption to rights issues by unlisted companies and issue of shares to employees of private companies from the operation of this provision. All listed companies seeking to raise capital should be subjected to the discipline of public issue along with the attendant regulation. In reckoning the 50 or more persons to whom the offer may be made, the Qualified Institutional Buyers (QIBs) may be excluded, since such entities would be informed investors and do not require the same level of detailed disclosures necessary for other investors. The capital market regulator may define QIBs appropriately. The Companies Act should acknowledge and take into account such categorization.

## Tracking and Treasury Stocks

14.1 Traditionally, companies issue shares, which represent the capital of the company, as a whole. Shares issued represent combined value of all divisions of the company. However, financial performance of one or more business undertakings could be considered as a basis for providing the shareholders benefits of the profits of such business undertaking. However, this will require a special category of shares to be issued termed as 'Tracking Shares' .Such Tracking Shares would confer on the holders thereof a right to participate in the dividend declared by the company based on the recommendation of the Board of Directors of the company from the profits of that particular division. The public issue of such tracking shares including as to initial and continuing disclosures may have to be governed by such rules, regulations or guidelines as may be prescribed by the capital market regulator. The accounting treatment of tracking shares and matters connected therewith would be governed by accounting standards for the purpose. It is felt that this concept would increase the depth of capital market. However, this would require development of specific accounting standards for the purpose as also development of monitoring and control mechanism by the Stock Exchanges and the Capital Market Regulator.

14.2 Section 77A of the Companies Act, 1956 provides for buy-back of securities. Once bought back the relevant securities are to be extinguished. Internationally, however, a company can, subject to certain restrictions, hold bought back shares in itself under the name "Treasury Stock". In other words, Treasury Stock are the shares which a company legitimately holds on its share register in its own name. The voting rights on these Treasury Stocks are suspended and company can not exercise voting rights on such shares. No distribution of dividend (including dividend during winding up) can be made to such stock.

14.3 There may be some advantage in this in raising of funds at a lower cost as and when need arises since public issue would be avoided. However, this concept could come in the way of operating market for takeover of management control which is an essential ingredient. Besides, monitoring and supervision requirements would be complex since such shares would not carry voting rights and would require to be tracked carefully by the market regulators. At this stage, this would impose additional regulatory complexity to prevent manipulation of shares, framing suitable accounting and taxation policies and recodifying the takeover code as a result of increase or decrease in shareholding.

14.4 The Committee felt that a number of preparatory actions were required before the concepts of Tracking Stocks and Treasury Stocks could be introduced, like regulations to be framed by capital market regulator, development of appropriate, specific accounting standards etc and therefore recommends that while an enabling provision for Tracking / Treasury Stocks could be incorporated in the new Law, actual introduction of Tracking and Treasury Stocks in the Indian Capital Markets will need to be preceded by the preparatory action referred to above and the instrument introduced only when the necessary framework is ready.

**Targeted Buy back**

15. The concept of targeted buyback, where an issuer may buyback shares from a subset of shareholders on a preferential basis was examined by the Committee. The

facility is used in some countries (a) effecting a block repurchase from large shareholders (b) effecting purchases from employees (c) thwarting takeover attempts. This concept is not yet addressed in Indian Law. This has been provided for in certain countries like USA, Australia etc. The Committee feels that this concept could come in the way of proper operation of a competitive market for management control which is an essential ingredient of the Capital Market. Therefore, the Committee does not find this mechanism to be appropriate at this stage.

**Perpetual Preference shares**

16. At present preference shares can be issued for a maximum period of 20 years. Since many companies may like to raise capital of a quasi equity and permanent nature on account of long gestation project capital requirements, it is felt that the concept of perpetual preference shares or preference shares of higher tenure may be permitted in the new Law. There should be flexibility to the company to revise the tenure by obtaining prescribed approval of shareholders for variation of rights. The Committee recommends that companies should be permitted to issue perpetual/ longer duration preference shares and that returns from such shares may be linked to market benchmark or reset periodically. In case the subscriber of perpetual preference shares wants to redeem his shares prematurely, necessary enabling provisions to redeem the shares by the company up to a certain percentage of preference shares on an annual basis may be provided. This may be done through "call/put option mechanism".

**Redemption and Dividend on Cumulative Redeemable Preference Shares**

17.1 If a company is redeeming cumulative preference shares by issue of fresh capital, the company should be permitted to raise necessary amounts through such issues to cover the arrears of preference dividend apart from the amount required for redemption of preference shares. This can be enabled whether or not the company had made adequate profits during the relevant financial year in which redemption is proposed to be carried out with a condition that interest on borrowed capital is paid.

17.2 The Committee further noted that the existing framework resulted in certain ambiguities in respect of arrears of cumulative preference dividend on conversion of such preference shares into equity shares, amalgamation/merger of a company having such arrears of preference dividend. The Committee is of the view that such ambiguities need to be resolved in a manner that the rights of holders of such shares, relatable to the period of such holdings are adequately protected.

**Capital Reduction**

18. In the existing Act the reduction of capital has to be approved by shareholders by way of special resolution followed by the sanction of the High Court. This is a time consuming process. In order to provide flexibility and time saving, it is appropriate that institutional mechanism such as the courts / proposed National Company Law Tribunal (NCLT) may decide on such issues in a time-bound manner with due safeguards for interests of creditors.

**Disclosure Norms**

19.1 In regard to access to Capital, there is a need for proper disclosure at every stage so as to make the business activities more transparent and investor friendly. There is a need for identification and disclosure of the critical accounting estimates and principles. Shareholders should be kept informed about all material facts which should also get posted on the website. There should be proper disclosure about the shareholding structure from time to time. Such disclosures should clearly reveal actual control structures through direct or indirect shareholding and should be made part of the Annual Report of the company. Thus, reduced regulatory intervention should be complemented by increased disclosure for effective capital market supervision.

19.2 The companies should be allowed to raise capital so long as they provide true and correct information to investors and the regulators. There could be flexibility to raise capital by making adequate disclosures. However non compliance with disclosure norms or raising money fraudulently should be subject to strict penalty regime

**Access to Public Deposits**

20.1 It was brought to the notice of the Committee that a number of complaints by depositors in respect of deposits made by them with corporate entities are being received by Ministry of Company Affairs (MCA) and Reserve Bank of India (RBI). There was, therefore, a view in the Committee that the provisions relating to allowing Non-Banking, Non-Finance Companies to accept deposits from public should be reviewed and that such companies be prohibited completely from accepting deposits. However, another view was that since acceptance of deposits is one of the ways through which companies (including Non-Banking, Non Finance Companies) raise finances, there should not be complete ban for accepting deposits. Instead, the norms for accepting deposits by such companies should be made stricter.

20.2. The Committee, therefore, feels that the regime of acceptance and invitation of Public Deposits should be made stricter. There could be two sets of process viz. Ex ante processes and Ex Post processes

**Ex-ante Processes :-**

Regulation including :-

(i) Disclosure requirement – The company accepting deposits should be mandated to make appropriate disclosures through issue of advertisement (text of which should be detailed and prescribed by way of rules) in the newspapers, one English and one vernacular. The application forms soliciting deposits should also indicate all such disclosures. Besides, there should be certain documents (like balance sheets / annual reports) of the company which should be open for inspection by potential deposit holders. On demand/payment of requisite fees, these should also be made available to potential deposit holders.

(ii) Compulsory credit rating – No company should be allowed to raise deposits unless it obtains a credit rating from SEBI registered Credit Rating Agencies. There should be a minimum credit rating prescribed in the Act / Rules for enabling any company to go for inviting deposits. Further, the rating should also be reviewable / renewable after every two years.

(iii) Creation of reserves – Besides maintaining certain percentage of deposits invited / accepted in liquid funds, every company inviting / accepting deposits should also be required to transfer certain amounts (out of profits) every year in a separate cash reserve created / earmarked only for the purpose of utilization for payment to deposit holders.

**Ex-post processes :-**

These should include setting up of a dispute resolution mechanism and penalties that deter irresponsible / fraudulent behaviour by corporates. Focus under such measures should be on bolstering confidence through an effective dispute resolution mechanism as well as penalizing of irresponsible/fraudulent behaviour by companies. A provision similar to Section 68 of the Act, presently covering punishment for fraudulent inducement for investment in shares should be made in respect of deposits also.

## Insurance for Deposit Holders

21. The Committee members deliberated on the issue relating to insurance for deposit holders. Though it was brought to the notice of the Committee that there are certain difficulties on the part of Insurance companies in treating "Deposit" as an insurable product, the Committee members felt that steps should be taken in consultation with insurance companies so that risk on the part of deposit holders is reduced through insurance. The Committee felt that deposit insurance mechanism should be enabled in consultation with Insurance Companies. Therefore the Committee recommends that public deposit should be allowed to be invited or accepted only on compliance of Ex-ante and Ex-Post processes which include sound internal controls, disclosure requirements, earmarking of reserves in respect of deposit amount and mechanism to resolve grievances and complaints of depositors. Further, the regulatory mechanism should provide for suspending future deposit taking activity in case of default in compliance with the rules relating to Acceptance of Deposits on the part of company.

## Registration of Charges

22. At present the provisions of the Act requires that both the borrower and the lender will have to sign the charge documents before filing with the ROC for registration. There have been instances where subsequent disputes between the borrower and the lender result in non compliance with the provisions requiring mandatory filing. This process has to be streamlined. Company Law Rules should be amended to provide if the borrower does not register the Charge within a fixed time, the lender may register the same in a specific time frame along with copies of relevant documents creating the change, with intimation to the Borrower.

## Non-cash consideration to be valued before allotment

23.1 The Law should specifically provide that a public company shall not allot shares as fully or partly paid-up otherwise than in cash, unless the consideration is independently valued by a valuer appointed by the company in consultation with the allottee and the valuation is made known to the allottee and the concerned Regulator. There may be suitable provisions to provide for an eventuality where a company is allotting shares in connection with its merger with another company, where one of the companies proposes to acquire all the assets and liabilities of the other company. The contents of the valuer's report may be specified by the Act / Rules. This would also serve to protect the Minority Interest. Committee feels that detailed provisions are also required to be provided in the Companies Act as there is a need for valuation of such non-cash consideration by independent valuers.

23.2 In the event a public company enters into an agreement to transfer non-cash assets to another public company, the consideration that has to be received by the company and any consideration other than cash that may be given by the transferee company, should be independently valued. A report in a specified format with respect to the consideration to be so received and given should be required to be made to the transferor company within a specified period preceding the date of agreement. The terms and conditions of such agreements should be subject to approval by the shareholders of transferor by an ordinary resolution.

**Inter-corporate loans and investments**

24.1 Subsequent to the abolition of provisions of Section 370 and 372 from the Companies Act w.e.f. 31-10-1998, the companies are allowed to self regulate inter-corporate loans and investments u/s 372A of the Act. Upon an examination of the nature of transactions that resulted in large amount of corporate funds which have been diverted to Stock Market for price rigging, the JPC on Stock Market Scam had recommended that suitable mechanism should be devised so that the corporate funds are not diverted to stock market and the prices rigging is checked. Diversion of funds through subsidiary and associate companies noticed during the course of examination of accounts of companies involved in Stock Market Scam-2001 indicate that the system of self regulation regarding inter-corporate loans and investments envisaged in the Companies (Amendment) Act, 1999 had not been very effective and requires a re-look. Necessary checks and balances for the self-regulatory mechanisms need to be put, so that the purpose of self regulation is served effectively.

24.2 The Committee feels that the provisions of the existing Section 372A of the current Act may be strengthened to ensure that there is no misuse of these provisions by corporates for price rigging or by diversion of funds. In particular disclosure requirements should be strengthened along with stringent penalties for non compliance. The law should ensure that the capacity of the corporate to invest or lend surplus funds is established transparently. There should be a prohibition on companies making loans to stock brokers and stock broking firm/stock broking companies subject to the exemptions presently provided under Section 372 A of the Act. However, this should not result in regime of Government approvals being re-imposed in this regard. The Committee was of the view that such approval could be accorded by way of Special Resolution. Further, detailed disclosures should be given in the Annual Report of the lending company about the end use of the loans and advances by the recipient entity for the intended purpose. Disclosures should also be prescribed in the explanatory statement attached with the notice for the meeting. Indian corporates should however not be placed at a disadvantage vis-à-vis companies incorporated in other jurisdictions in any international competitive bidding situation for acquisitions.

**Preferential Allotments**

25. The Preferential issue of equity shares/fully convertible debentures/partly convertible debentures or any other financial instruments at a price unrelated to the prevailing market is a common source of raising capital. This practice is particularly undesirable as the allotments are made to a select group of persons (even to promoters) which may be against the interest of the other investors. SEBI has framed regulations for allowing preferential allotments which require passing of special resolution, disclosures to be sent to shareholders and a pricing formula depending on stock market quotations of the company. It is, therefore, necessary to impose appropriate conditions for such allotments by unlisted public companies including for proper valuation of shares, compliance of which should be made obligatory before a public company issues shares on preferential basis. It is felt that in case of unlisted public companies, such allotment should be made subject to valuation by independent valuers. The Committee therefore recommends that the Law should provide that in case of public unlisted companies, preferential allotment can be made on the basis of valuation by an independent valuer.

**Penalty for fraudulently inducing persons to invest money**

26. The provisions of the Companies Act relating to penalties for fraudulently inducing persons to invest money should be made more stringent. The practice relating to imposition of penalties under provisions in the present Companies Act have been found to ineffective since there are not many cases under which punishment has actually been imposed. The legal procedure associated with such prosecution should be revisited so as to make the process more effective. The offence of fraudulent inducement should be non-compoundable. The Government may also consider actions such as attachment of bank accounts in such cases subject to the orders of Judicial Magistrate First Class.

**Allotment where issues are not fully subscribed**

27. Section 69 of the present Act prohibits allotment of shares unless minimum subscription is received. The Act does not contemplate allotment where issues are not fully subscribed. It has to be left to the management to decide whether it can proceed to allot the shares even if issues are not fully subscribed, particularly when the capital market is volatile. The offer letter or the prospectus must indicate the consequences when the issues are not fully subscribed and the conditions stipulated, if any, in the matter. The Law may allow, subject to adequate disclosures and fulfillment of conditions prescribed, to retain subscription received pursuant to Public Offer so made, notwithstanding non-receipt of amount of minimum subscription. The capital market regulator should also consider suitable changes to enable such public offers.

**Shares with differential Voting Rights**

28. The Companies Act was amended in the year 2000 for providing issue of equity shares with differential voting rights. However, the Committee noted that there was a lack of clarity in the Rules. Also, there were no corresponding amendments effected in

Section 87 of the Act. As a result no corporate could avail of the benefits of this provision. The Committee felt that introduction of concept of shares with differential voting rights should be retained. However, clarity should be brought about in the framework of associated rules to enable proper use of such instrument.

## NIDHI Companies

29.1 The Companies Act empowers the Central Government to declare a company to be a NIDHI or mutual benefit society. The genesis of this amendment lies in the recommendation of the Company Law Amendment Committee in 1960 that the object of the NIDHI companies was to enable the members to save money and to secure loans at favorable rates of interest. The companies inculcate the habit thrift in the public. The shares of such companies are not offered to the public for subscription. Since application of some of the provisions of the Companies Act creates hardship and cripples slender resources available to such companies, they have also been provided with certain exemptions from time to time.

29.2 Initially the area of operation of the NIDHI companies was local – within Municipalities and Panchayats. However, some NIDHIs on account of their financial and administrative strength opened branches even out side their local territories though the principle of mutual benefit remained fundamental to them.

29.3 A few failures of leading NIDHI companies caused by mismanagement of those in control and involving lakhs of depositors, led the Government to constitute a Committee under the Chairmanship of Shri P. Sabanayagam to examine the various aspects of the functioning of NIDHI companies. The Committee recommended deployment of funds in deposits in Nationalised Banks, sanction of loans against specified security and as a percentage of the value of a property offered as security, fixing of ceiling of interest on deposit, restriction on opening of branches, applicability of prudential norms for income recognition and classification of assets of the NIDHI companies. Subsequently, the Government has enabled application of prudential norms in matters relating to income recognition and classification of assets and provisioning for non performing assets.

29.4 NIDHI companies are effectively non-banking financial companies and are engaged in the business of accepting deposits and making loans to their members. The recent failures in the NBFC sector also extended to the NIDHI companies compelling the Government to introduce strict prudential norms for such companies. The deposit taking activities of NIDHIs are governed by the RBI Act and guidelines made thereunder. The power to give exemptions to the NIDHI companies in the administration of NIDHI i.e. with the Ministry of Company Affairs. This dual control leads to confusion in the administration of the provisions of the RBI Act and the Companies Act, 1956. Since, RBI is the regulator of all the NBFC incorporated under the Companies Act, the Committee felt that NIDHI companies should also be controlled by RBI through close supervision.

## Debenture Redemption Reserve (DRR) in case of NBFCs/Other Companies

30. A view has been expressed that the concept of DRR is not relevant in the case of NBFCs where debentures are raised for financing assets under Hire Purchase or Leasing which are self liquidating in nature. Keeping in view the requirement of

NBFCs, the Government has provided some exemptions from this requirement to NBFCs by issuing circulars. While doing so, the obligation on the part of NBFCs to maintain a percentage of assets in unencumbered approved securities and creation of reserve funds to an extent of 20% of net profits etc. The financial prudential norms under which Banks and NBFCs operate are regulated by the RBI. To avoid regulatory overlap, we are of the view that RBI should make suitable provisions in this regard. The existing exemptions to NBFCs may continue till such time. However, for the other companies, the Company Law should provide an enabling provision to enable the Central Government to regulate the limits of DRR.

**Relevance of Present Section 208**

31.1 Section 208 of the Companies Act enables payment of interest on share capital subject to conditions prescribed in the said Section. The use of word 'interest' instead of dividend distinguishes returns paid out of capital and returns paid out of profits.

31.2 As per Section 208 (1)(b) of the Companies Act, the interest on capital paid pursuant to Section 208 can be charged to capital which may lead to cost overruns of long gestation projects. The return on the investment in favour of the shareholders also acts as a disincentive on the part of the shareholders to push for early completion of the project

31.3 Further, rates of interest are decided by the market forces and the policy of the Reserve Bank of India in vogue from time to time.

31.4 The arena of corporate financing has undergone several changes since inception of Section 208 in 1956. Corporates are increasingly resorting to a variety of instruments to finance infrastructure projects and alternative forms of financing are available at rates of interest which are market driven. Section 208 of the Companies Act has, therefore, outlived the purpose for which it was introduced. The Committee therefore took the view that Section 208 should be deleted from the provisions of the Companies Act.

## Chapter IX : Accounts and Audit

1. Proper and accurate compilation of financial information of a corporate and its disclosure, in a manner that is standardized and understood by stakeholders, is central to the credibility of the corporates and soundness of investment decisions by the investors. The preparation of financial information and its audit, therefore, needs to be regulated through law with stringent penalties for non-observance. It would however, not be feasible for the law to prescribe all the details guiding the treatment of this subject. This is a technical matter which needs to be gone into by experts keeping in view the requirements of proper disclosures of financial information in the interests of healthy corporate governance. However, once developed, use of such principles should be mandated through law. Accounting Standards serve a vital function in this respect. These should be developed keeping in view international best practices and

provided statutory backing. There should be integration of Accounting Standards with substantive law.

## Institutional mechanism for developing Accounting Standards

2. The present statute provides for a mechanism for development of Accounting Standards. We understand that Accounting Standards for the use of Indian corporate sector, taking into account International Accounting Standards, are being developed through the instrumentality of the National Advisory Committee on Accounting Standards (NACAS). This is an important aspect that needs to be pursued. In the meantime, the Institute of Chartered Accountants of India (ICAI) has done useful work in prescribing operational standards of accounting to fill the gap till Accounting Standards could be notified. We expect that the process of notification of Accounting Standards, incorporating international best practices, would be completed shortly.

3. The Committee took note of the contribution made by the ICAI and the NACAS in development of proposals for Accounting Standards and took the view that the existing institutional mechanism for formulating and notifying Accounting Standards under the Companies Act, 1956 may be retained.

## Holding-Subsidiary Accounts and Consolidation

4. The Committee took the view that consolidation of financial statements of subsidiaries with those of holding companies should be mandatory. The Committee discussed the question of the manner of maintenance of accounts of entities other than companies but controlled by companies registered under the Act. With the proposed consolidation of accounts by holding companies, the Committee felt the need for prescribing maintenance of proper records by a non-corporate entity which is controlled by a company to which the provisions of the Act apply. This is because companies are now increasingly controlling entities such as partnership firms, special purpose vehicles, associations, etc. which are non-corporate bodies. Further, the responsibility for proper maintenance of records in such cases should be that of the holding company.

5. With consolidation of financial statements by holding companies on mandatory basis, the provisions requiring attaching the accounts of subsidiary companies with those of holding companies, for circulation to shareholders in accordance with the provisions of the present Companies Act should be done away with. In case the financial statements of a foreign subsidiary are required to be furnished to the shareholders of the holding company, these should be accepted in the same format and currency in which these were prepared as per laws of the relevant country. With implementation of e-governance project, it should be possible to view the records of the companies filed with Registrars through electronic media. Notwithstanding this, both holding and subsidiary companies should be encouraged to make greater use of electronic media to make their published financial accounts available for viewing.

6. Further, the Committee took the view that the holding companies should be required to maintain records relating to consolidation of financial statements for specified periods. Presentation of consolidated financial statements by the holding

company should be in addition to the mandatory presentation of individual financial statements of that holding company.

## Preservation of Records by the Companies

7. At present, Section 209 (4A) of the Act requires companies to preserve the books of accounts, together with the vouchers relevant to any entry in such books of account, in good order, relating to a period of not less than 8 years immediately preceding the current year. The Committee felt that the rules may provide for preservation of books of account and records of the company for a period of 7 years to bring it in harmony with Income Tax Act.

## Form Of Accounting Records And Accounting Standard

8. In order to bring about more transparency and uniformity in the maintenance of accounts, the Committee felt that the companies should continue to be mandated to maintain their books of accounts on accrual basis and double entry method of book keeping. The question arose before the Committee as to whether the form and content of the financial statements needs to be specified separately in the Act or should be left to the Accounting Standards prescribed by the Central Government in consultation with NACAS. After considerable deliberations, it was decided that the form and content of the financial statements and the disclosures required therein need to be provided for under the Act/Rules. Any changes made in the Accounting Standards could be factored in the Act/Rules from time to time. It was also decided that the companies should be given the option to maintain the records in electronic form capable of conversion into hard copy.

## Maintenance of Records Outside the Country

9. The companies should have an option to keep records outside the country provided financial information in compliance with the Companies Act is available within the country and written notice is given to the Registrar of the place where the records are kept. However, such a Company should be obligated to produce the records that are kept outside the country, if and when required to do so as specified in the Rules.

## Cash Flow Statement To Be Made Mandatory

10. World over, the importance of Cash Flow Statement is being specifically recognized. At present, the listed companies are mandated to include a Cash Flow Statement in the Annual Report and the Standards of Accounting prescribed by ICAI also requires in specified cases a Cash Flow Statement to be submitted along with the Balance Sheet and Profit & Loss Account with a view to make Cash Flow Statement mandatory. The Committee felt that there was a need to include the definition of the term Financial Statement in the Act, to include Profit & Loss Account, Balance Sheet, Cash Flow Statement and Notes on Accounts.

**Relaxation/Exemption To Small Companies**

11. The Committee was of the view that Small Companies need not be subject to the costs of a regime suited to large companies with a wide stakeholder base. Relaxations to small companies with regard to the format of accounts to be prescribed in the Act/Rules may also be considered. If necessary, a separate format for small companies may be devised. Exemptions from certain disclosures may also be considered and relaxations, if any required, in respect of compliance with Accounting Standards may be provided for while notifying the Accounting Standards. If necessary, a separate Accounting Standard may be framed for small companies.

**Financial Year**

12. The Companies Act at present does not contain any provision relating to the minimum period of a Financial Year. The Concept Paper has defined the Financial Year with the minimum period of six months. The Committee dwelt on the subject and came to the conclusion that the first financial year should begin from the date of incorporation and end on the immediately succeeding 31st March and the subsequent Financial Years should also end on 31st March every year. The definition of Financial Year may be modified to indicate that the duration of the first Financial Year should be minimum three months instead of the six months proposed in the Concept Paper (2004). It was also suggested that the present provisions regarding laying down of the accounts before the shareholders within six months of the end of the Financial Year should continue.

**Authentication, Circulation and Revision Of Financial Statements**

13. The Committee discussed at length the existing provisions of the Act regarding approval and authentication of accounts, circulation of accounts and filing of accounts with the Regulatory body. The Committee was of the view that the concept of appointment of CFO should be recognized under the Act who should be made responsible for preparation and submission of financial statements to the Board. The financial statements should also be signed by Managing Director, CEO, CFO, and the Company Secretary wherever such functionaries are mandated, whether or not they are present at the Board meeting at which the accounts are adopted. All the Directors who were present in the meeting which approved the accounts should also be mandated to sign the accounts. If a Director dissents, he should also sign the financial statement with the dissent note.

14. It was brought to the notice of the Committee that provisions should be made in law for revision of accounts after its adoption/approval by the shareholders subject to conditions laid down under the law. This should however be possible only in cases where changes in law necessitate restatement with retrospective effect or for rectifying the errors apparent from the records.

15. The provisions under the Companies Act relating to circulation of financial statements should continue. However, the Committee recommended that the financial statements should be permitted to be sent by electronic means instead of hard copy. In the case of listed Companies. Where abridged financial statements are circulated amongst members, the full financial statements should be made available on the web-site and the hard copy thereof should also be made available on request.

**Directors' Responsibility Statement**

16. The Committee noted that the Companies Act was amended by inserting section 217 (2AA) by the Companies (Amendment) Act, 2000, which has brought about inclusion of Directors' Responsibility Statement in the report of the Board of Directors. The Committee was of the view that in addition to the existing requirements, the Responsibility Statement should include that the related party transactions and have been entered into at arm's length, and if not, the relationships of the directors in such transactions along with the amounts involved have been disclosed as a part of the Director's Report along with management justification thereof. The existing requirement in Section 217 (2AA) requiring a Director Responsibility statement indicating that the Directors have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Act and that the books of accounts comply with the accounting standards and policies should continue.

**Other Recommendations**

17. The Committee discussed other miscellaneous matters in relation to definition of certain terms such as "derivative", "employees stock option", "net worth" etc. the need for rules relating to "Transfer of Profit to Reserves" and "Declaration of Dividend out of Reserves" and related matters. The Committee took the view that the definition of term "derivative" could be omitted from the Companies Act. However, definitions of the terms "Employee Stock Option" and "Networth" may be retained with appropriate modifications to reflect their meaning as per generally accepted terminology. After a detailed debate relating to declaration of dividend only out of the profits of the Company arrived at after complying with the Accounting Standards, the Committee endorse this principle for declaration of dividend.

18. The Committee also took the view that the two sets of existing rules relating to declaration of dividend out of reserves and transfer of profit to reserve were irrelevant in the present environment and may be deleted.

19. The relevance of Section 205(2)(c) of the Act requiring companies to write off at least 95% of the original cost of the asset to the Company was discussed at length. The Committee agreed that there need not be any restriction of writing off 95% of the original cost to the company of the asset over a specified period, on the Central Government in approving the basis of providing depreciation.

20. The measure of depreciation is based on three important parameters viz. depreciable amount, estimated useful life and estimated scrap value. The policy of liberalization of the economy has brought about a public-private co-operation especially in infrastructure projects. Such projects are taken up under BOOT or BOT structure. The general tenure of the agreement in such structures is that the Special Purpose Company (SPC) would be required to ensure construction of the facility and maintenance of the facility to ensure the required quality of service during the concession period. The asset is handed over by the SPC to the Government or its agencies in a physical condition which is similar to the condition at the start of the project. It is therefore necessary that the method of providing for depreciation by the SPC should be administered in a different manner.

21. Law needs to recognize a modified approach for providing depreciation to the assets coming under the category of infrastructure assets. In fact, in some countries, law has recognized that there cannot be a statutory limit on the useful life of a capital asset. Expenditure incurred/to be incurred to maintain the operating capabilities of such eligible assets could be charged off towards permissible depreciation. The Company Law should provide a framework that recognizes rates of depreciation for infrastructure projects where such rates are prescribed by statutory regulator for concerned sector. In all other cases, rates of depreciation may be provided taking into account the special requirements of infrastructure sector, as applicable to a class of projects, under the Company Law.

## AUDIT

### Appointment of Auditors

22. The issue of appointment of First Auditor of the Company and his subsequent appointments were discussed at length. The relevant provisions as existing in Indian law vis-à-vis those prevalent in USA, UK, Australia and Canada were also discussed. The Committee acknowledged the role of the Audit Committee wherever such Committees were mandated, in recommending the appointment of the Auditors to the Board in general. The Committee recommended that the existing provisions relating to appointment of first Auditor to be made by the Board, failing which by the shareholders and the power of the Central Government to appoint the Auditors whenever the Board/shareholders fail to appoint them were necessary and should continue. The Company should also be required to send intimation to the Registrar of Companies regarding appointment of First Auditors, within 7 days of such appointment.

23. Subsequent to the appointment of First Auditors, the appointment of Auditors should be done on AGM to AGM basis with a power to the Board to fill any casual vacancy. There should not be any situation where the company is without duly appointed Auditors. Such appointment of Auditors should be made by the shareholders taking into account the recommendations of the Board, which, in turn should be arrived at after obtaining the recommendations of the Audit Committee, where such a Committee is mandated or is in existence. In case any of the shareholders wish to propose any other Auditor in place of retiring Auditors, this

process should also necessarily seek the views of the Audit Committee. There should be an obligation to intimate appointment of Auditor to Registrar of Companies by the Company within 7 days.

**<u>Remuneration of Auditors</u>**

24. The Committee discussed the provisions relating to the payment of remuneration to the Auditors and felt that this should be subject to decision by shareholders and that the provisions in the existing law provided a suitable framework for the purpose. However, the Committee felt that the basic remuneration to be termed as 'Audit Fee' should be distinguished from reimbursement of expenses. Reimbursement of expenses to Auditors should not form part of remuneration but should be disclosed separately in the Financial Statements along with the Auditor's fees.

**<u>Rotation of Auditors</u>**

25. There was a detailed discussion on the need for rotation of Auditors. The view that rotation of Audit partner should take place every five years in the case of all listed Companies was also considered by the Committee. However, the Committee thought it fit that the matter of change of Auditors be left to the shareholders of the Company and the Auditors themselves rather than be provided under law.

**<u>Provision of Non-Audit Services</u>**

26. The Committee took note of the fact that rendering of non-audit services by Auditors of the Company was ~~is~~ a matter of general concern. The Committee was of the view that rendering of all services by the Auditors which were not related to audit, accounting records or financial statements, should not be prohibited from being rendered by the Auditors subject to a prescribed threshold of materiality. All non audit services may however be pre-approved by Audit Committee where such a committee is mandated or in existence.

An Audit firm should however be prohibited from rendering the following non audit services to its audit client and its subsidiaries:

- Accounting and book keeping services relating to accounting records.
- Internal Audit
- Design and implementation of financial information systems including services related IT systems for preparing financial or management accounts and information flows of a company.
- Actuarial services
- Investment Advisory or Investment banking services
- Rendering of outsourced financial services.

- Management function including provision of temporary staff to audit clients.

## Disqualification of Auditors

27. The Committee deliberated on issues relating to disqualification of Auditors. The relevant provisions of the Companies Act in different countries including those existing in India as well as the views of the ICAI on the matter were discussed. The Committee was of the view that the Auditors' position and responsibilities involved access to sensitive market information particularly relating to the profits of the company. There was a possibility of misuse of such information. A view was expressed that the existing ban on an Auditor owning securities of the auditee company should be reviewed and that a concept of materiality be introduced. Considering the wide variation in the sizes of companies, a common prescription to be legislated under law would be difficult. The Committee, therefore, feels that at present there may not be any change in the existing framework. However, the matter may be examined further by the Government in context of the framework of ethical conduct and statutory requirements under the Chartered Accountants Act, 1949 in consultation with ICAI. The conclusions that emerged out of the discussions and deliberations are summed up as follows:

- The amount of indebtedness/guarantee be increased beyond the present limit of Rs.1,000/- and such a limits could be prescribed under Rules.
- The indebtedness/guarantee of the Auditors should also be extended to cover indebtedness/guarantee to the Directors and all entities whose financial statements are required to be consolidated under the Act.
- The disqualification envisaged under the Act/Rules should be applicable not only to the Auditors but also to his relatives, (the term relatives being defined under the Companies Act) any of the associates of the auditor and any entity in which the Auditor has a substantial interest.
- The Auditor should disclose holdings in the securities of the company, if any, at the time of appointment. However, the Committee feel that the Auditor would be privy to insight financial information of the company and there could be possibility of making wrongful gain by the Auditors by mis-utilizing such information. The work of the Auditor should be credible and free from conflict of interests. Therefore, the Committee are not in favour of relaxing the prohibition on holding of shares or securities of the subject company by the Auditor. The matter should be examined by the Government in consultation with the ICAI.

## Appointment of Auditors other than Retiring Auditors

28. The Committee discussed and agreed that the existing provisions of the Companies Act relating to appointment of Auditors were well established and should continue. However, the retiring auditor should be appointed if in the Annual General Meeting, the accounts of the company for the immediately preceding financial year are not approved.

## Duties and Liabilities of Auditors

29. Auditors have the general duty of discharging their statutory functions with care and diligence. Many stakeholders would rely on the auditor's reports for accessing the financial picture of the company. However, there cannot be any specific prescription of negligence keeping in view the expectations of all the stakeholders. However, auditors are required to carry out their work within the discipline of the legal provisions and the standards of accounting/Accounting Standards (where notified). There is a necessity that the work of the auditors should uphold the highest standards of excellence and independence. Non-compliance with such standards should invite stringent penalties. The Committee was of the view that the basic duties of the Auditors and their liability need to be laid down in the law itself instead of in the Rules. Quantification of penalty for Auditors may be prescribed in the Rules.

## Powers of Auditor of a Holding Company

30. A view was expressed that the Auditor signing the consolidated financial statement should be empowered to access the books, records and documents of the entities whose accounts are consolidated. It was also felt that such right of the Auditor would be subject to the rules to be framed under the Act. In view of the legal position that a statutory auditor will not be able to access to all books and records of all entities whose accounts are consolidated, by virtue of the limitations of his appointment in the holding company, adequate records stating the basis for consolidation of accounts should be made available to him.

## Certification of Internal Control by CEO/CFO

31. The Committee dwelt at length matters connected with Audit and the basic principles governing Audit. The Committee felt the need for a high quality of financial reporting, a strengthened corporate governance mechanism, an independent audit and fearless expression of opinion by the Auditors. The Committee feels that the internal controls in any organization constitute the pillar on which the entire edifice of Audit stands. For this purpose, it was felt that public listed companies be required to have a regime of internal financial controls for their own observance. Active interest of the shareholders' association in improving the quality of financial reporting, investor education for better understanding of the financial statements combined with presence of internal controls would provide for effective financial reporting.

In sum :-

- Internal controls as mandated by the company with the approval of the Audit Committee, if any, should be certified by the CEO and CFO of the Company and in the Directors report through a separate statement on the assessment.
- The investors be educated and imparted with better understanding and appreciation of the financial statements. The law should also provide for an active role for the shareholders' associations in ensuring high quality of financial reporting.

## The Audit Committee

32. While considering issues relating to management and governance structures in a company (Chapter IV, para 17.1), this Committee has recommended a committee of the Board on accounting and financial matters to be termed as the Audit Committee.

33. All matters relating to appointment of auditors, examination of the auditor's report along with financial statements prior to consideration and approval by the Board, related party transactions, valuations and other matters involving conflicts of interest should also be referred to the Board only through the Audit Committee.

**Cost Audit**

34. At present, the Companies Act contains provisions relating to maintenance of Cost Records under section 209 (1) (d) and Cost Audit under section 233B of the Companies Act in respect of specified industries. The Committee felt that Cost Records and Cost Audit were important instruments that would enable companies make their operations efficient and exist in a competitive environment.

35. The Committee noted that the present corporate scenario also included a sizeable component of Government owned enterprises or companies operating under administered price mechanism or a regime of subsidies. It would be relevant for the Government or the regulators concerned with non-competitive situations to seek costing data. The Committee, therefore, took the view that while the enabling provision may be retained in the law providing powers to the Government to cause Cost Audit, legislative guidance has to take into account the role of management in addressing cost management issues in context of the liberalized business and economic environment. Further, Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary.

**Special Audit**

36. The Committee felt that the provisions in the present Act requiring Special Audit under certain circumstances were not relevant in view of the detailed investigation provisions recommended by the Committee. During the course of investigation, it is expected that the inspector would have access to the specialized expertise of various professionals as may be required. Further, such investigation may be carried out by private professionals operating individually or in teams. In this background, Special Audit taken in isolation would serve no useful purpose and may be dispensed with.

**Audit of Government Companies**

37. The Committee discussed the application of the corporate law framework to Government companies on many occasions and took the view that in general, there should not be any special dispensation for such companies. In respect of audit of Government companies however, Companies Act provide a special regime. Pursuant to Section 19(1) of Comptroller and Auditor-General's Duties, Powers and Conditions of Service Act, 1971, audit of the accounts of Government companies is conducted by the Comptroller and Auditor General (C&AG) in accordance with the provisions of the Companies Act, 1956, the Auditor (Chartered Accountant) of a Government Company is appointed or re-appointed by the C&AG. It is further stipulated that C&AG shall

have the power to (a) direct the auditor to conduct the audit in a specified manner, (b) give instructions on any matter relating to the performance of his functions, (c) conduct himself a supplementary or test audit of the company's accounts and (d) comment upon or supplement the audit report in such manner as he (C&AG) thinks fit. The comments of C&AG are to be placed before AGM along with Auditor's Report.

38. The Committee noted with concern the delays in finalization of the accounts of Government companies. In many cases, Government companies and their directors become liable for penal action but are provided selective exclusions from their liabilities only because they are Government companies. This is leading to an unhealthy situation which must be addressed.

39. While considering classifications of companies in Chapter III of this Report, the Committee discussed the manner in which company law should apply to Government companies (Chapter III, para 7.1-7.4). The law should clearly provide the definition of a Government company in context of ownership of the Central and/or State Government. Therefore, the extension of special exemptions and protections to various commercial ventures taken up by Government companies in the course of their commercial operations along with strategic partners or general public should be done away with so that such entities can operate in the market place on the same terms and conditions as other entities. In particular, reflection of financial information of such ventures by Government companies and their audit should be subject to the common legal regime applicable. The existing delays are enabling a large number of corporate entities to evade their responsibilities and liability for correct disclosure of true and fair financial information in a timely manner. In this context, the relevance of the present section 619B of the Act was considered appropriate for a review.

40. The Committee felt that since statutory audit is conducted by the statutory auditor appointed by the C&AG in the manner directed by him, the test/supplementary audit is superfluous since it would duplicate audit work already done by statutory auditor. Further, where any directions are given by the C&AG to the Statutory Auditor not in accordance with the Accounting Standards, the Statutory Auditor may be required to mention the same in the notes on accounts.

## **Chapter X** : **Mergers and Acquisitions**

1. A business may grow over time as the utility of its products and services is recognized. It may also grow through an inorganic process, symbolized by an instantaneous expansion in work force, customers, infrastructure resources and thereby an overall increase in the revenues and profits of the entity. Mergers and acquisitions are manifestations of an inorganic growth process. While mergers can be defined to mean unification of two players into a single entity, acquisitions are situations where one player buys out the other to combine the bought entity with itself. It may be in form of a purchase, where one business buys another or a management buy out, where the management buys the business from its owners. Further, de-mergers, i.e., division of a single entity into two or more entities also require being recognized and treated on par with mergers and acquisitions regime as recommended below, and accordingly references below to mergers and acquisitions also is intended to cover de-mergers (with the law & Rules as framed duly catering to the same).

2. Mergers and acquisitions are used as instruments of momentous growth and are increasingly getting accepted by Indian businesses as critical tool of business strategy. They are widely used in a wide array of fields such as information technology, telecommunications, and business process outsourcing as well as in traditional business to gain strength, expand the customer base, cut competition or enter into a new market or product segment. Mergers and acquisitions may be undertaken to access the market through an established brand, to get a market share, to eliminate competition, to reduce tax liabilities or to acquire competence or to set off accumulated losses of one entity against the profits of other entity.

3. The process of mergers and acquisitions in India is court driven, long drawn and hence problematic. The process may be initiated through common agreements between the two parties, but that is not sufficient to provide a legal cover to it. The sanction of the High Court is required for bringing it into effect. The Companies Act, 1956 consolidates provisions relating to mergers and acquisitions and other related issues of compromises, arrangements and reconstructions, however other provisions of the Companies Act get attracted at different times and in each case of merger and acquisition and the procedure remains far from simple. The Central Government has a role to play in this process and it acts through an Official Liquidator (OL) or the Regional Director of the Ministry of Company Affairs. The entire process has to be to the satisfaction of the Court. This sometimes results in delays.

4. Needless to say, in the context of increasing competitiveness in the market, speed is of the essence, especially in an expanding and vibrant economy like ours. A sign of corporate readiness, skill and stratagem is the ability to do such mergers and acquisitions with 'digital' speed. E-governance could provide a helpful tool in achieving the objective of speed with provisions for online registration, approvals etc.

5. The Committee was of the view that contractual mergers may be given statutory recognition in the Company Law in India as is the practice in many other countries. Such mergers and acquisitions through contract form (i.e. without court intervention), could be made subject to subsequent approval of shareholders by ordinary majority. This would eliminate obstructions to mergers and acquisitions, ex-post facto protection and ability to rectify would be available.

6. There has been a steady increase in cross-border mergers with the increase in global trade. Such mergers and acquisitions can bring long-term benefits when they are accompanied by policies to facilitate competition and improved corporate governance.

7. The Committee went into several aspects of the provisions in the existing law constituting a separate code in themselves and regulating a very important aspect of restructuring and consolidation of business in response to the economic environment. An effort was made to identify the areas of concern under the present law and to recommend means of addressing them.

8. At present, in case of a proposed scheme for amalgamation of company which is being dissolved without winding up, the law requires a report from the Official Liquidator (OL) or Registrar of Companies (ROC) that the affairs of company have not been conducted in a manner prejudicial to the interest of its members or to public interest. The Act also requires that no order for dissolution of any transferor company shall be made by the Court unless the OL makes a report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest. The Committee felt that the above two requirements under the present law can be covered by issuing notices to ROC and OL respectively; who may file before the Court, information that may have a bearing on the proposed merger. There is no requirement of a separate information in response to the notice to be filed for the purpose. Filing of such report may be time-bound, beyond which it may be presumed that ROC/OL concerned have no comments to offer.

**Single window concept.:**

9. The law should provide for a single forum which would approve the scheme of mergers and acquisition in an effective time bound manner. The law should also provide for mandatory intimation to regulators in respect of specified class of companies. The concept of 'deemed approval' should be provided for in cases where the regulators do not intimate/inform their comments within a specified time period to the Court/Tribunal before which the scheme of merger/amalgamation is submitted for approval.

**Valuation of shares:**

10. The Committee while discussing this aspect in detail, also took into account the Shroff Committee Report on "Valuation of Corporate Assets and Shares" during the

course of its deliberation on the subject and took the view that valuation of the shares of companies involved in schemes of mergers should be made mandatory in respect of such companies. It was also recommended that such valuation should be carried out by independent registered valuers rather than by Court appointed valuers. The law should lay out the exception, if any, to the mandatory valuation requirements. The law should also recognize valuation of incorporeal property. Valuation standards may also be developed on the lines of 'International Valuation Standards' issued by the International Valuation Standards Committee. The valuation should be transparent so that the aggrieved person may get an opportunity to challenge the same before Court/Tribunal. Benchmarking of valuation techniques and Peer Review Mechanism for Valuers should also be provided for.

11. Where an Audit Committee is mandatory for a company, the task of appointing the valuer should be entrusted to the Audit Committee. The Audit Committee should also have the duty to verify whether the valuer has an advisory mandate and had past association with the company management. The Audit Committee should verify the independence of the valuer for the purposes of an independent valuation. In the case of companies not required to have Audit Committee, this task should be carried out by the Board.

**Registration of merger and acquisition**

12. The Committee discussed with concern, the differential stamp duty regime prevalent in different States, which inhibits merger and acquisition activity. It has been a question for consideration whether an order of a court sanctioning a compromise/arrangement under Sections 391-394 of the Companies Act, 1956 would be stampable as a "conveyance" at the rates applicable to such entry in the various state Stamp Acts. Certain states like Maharashtra, Gujarat, Karnataka and Rajasthan sought to address this problem by amending their stamp legislations to make an order of the High Court under Sections 391-394 stampable. However, majority of the states in India have not adopted this stand, resulting in a confusion on the issue. This confusion is more acutely present in the case of mergers of companies that have registered offices in different states. However, as this subject falls within the domain of the States under the Constitution, the States will have to take initiative in this regard. It would be appropriate for the Central Government to facilitate a dialogue in this regard.

13. The Concept Paper on Company Law (2004) contemplates that an order of the scheme of merger will be effective only if a certified copy of the order of the Court is filed with the Registrar and duly registered. The Committee felt that it should be enough if the company complies with the filing requirement with the Registrar of Companies as is presently provided, to make the scheme effective.

14. The Committee also felt that a separate electronic registry should be constituted for filing schemes under Sections 391/394 of the Companies Act. Instead of filing the schemes with the Registration Offices wherever the properties of the company are

located, filing the scheme with the electronic registry should be considered sufficient compliance. This however, could raise jurisdictional issues vis-à-vis Stamp Duties applicable which may be resolved by an appropriate Constitutional amendment to enable a uniform, reasonably priced Stamp Duty regime across the country. Further, there must also be a provision in the Company Law for compulsory registration with the electronic registry of all property of a company above a certain value. This will simplify the mutation procedure subsequent to scheme of arrangement between two or more companies. The Committee took the view that enabling uniformity and overall reduction of Stamp Duties applicable in pursuance of mergers, demergers, amalgamations or schemes of reconstruction, takeover would be desirable as competition requires cost reduction and Indian firms need to be competitive in restructuring exercise in the global context.

**Merger of a listed company into an unlisted company and vice-versa:-**

15. The Committee examined issues relating to the merger of listed company with an unlisted company and vice-versa. It was felt that the Act needs to provide specifically that de-listing through a scheme of merger under section 391-394 of the Companies Act is possible by merging a listed company with an unlisted company. However, such a process should enable a safety net or a clear exit option for the public shareholders of the listed company. Similarly, if substantial assets are moved out of a listed company in the case of de-merger, a safety net/exit option needs to be provided to the public shareholders and the residual company needs to be de-listed (in case more than 90% of the public shareholders exercise such option).

16. The law should enable companies to purchase the stake of minority shareholders in order to prevent exploitation of such shareholders where a promoter has bought back more than 90% of the equity. Such purchase should, however, on the basis of a fair offer. Appropriate valuation rules for this purpose should be prescribed, or, the last known price prior to delisting, could be made the benchmark for such acquisitions.

**Approval of the Scheme**

17. The existing Law requires that a scheme for merger and/ or any arrangement should be approved by a majority in number representing also $3/4^{th}$ in value of shareholders/creditors present and voting. The requirement of majority in number does not serve any useful purpose considering that value is simultaneously being considered as a criterion. Besides, international practice recognizes value as the determining factor and does not appear to impose such additional conditions. The Committee is, therefore, of the view that this requirement, in Indian law, may also be modified to provide only for approval by $3/4^{th}$ in value of shareholders and creditors, present and voting.

18. Under the present scheme of Act, the manner of holding of the meetings of the creditors and shareholders as also dispensing with the same is left to the discretion of the courts. However, different courts follow different procedures. The Committee feels that there is a need for uniformity in this regard and recommends that rules may be formulated under the Act to cover this aspect, including dispensing of the requirement to hold such meetings.

## Minority Interest

19. The Committee examined the view that quite frequently shareholders/creditors with insignificant stake raise objections to schemes of merger/acquisition and the process of dealing with such objection becomes vexatious. After a detailed discussion, the Committee recommended that while protection of minority interest should be recognized under the law, only shareholders/creditors having significant stake at a level to be prescribed under law should have the right to object to any scheme of mergers. The philosophy behind such a move would be to streamline the procedure of articulation of the minority interest while restricting obstructionist attitude on the part of any section of minority.

## Merger of class of Companies

20. The Committee reviewed the international models of mergers and amalgamations. In the case of mergers within a group, the Act may prescribe a short form of amalgamation. Conceptually a scheme of amalgamation or merger between holding company and subsidiary company stands on a different footing from amalgamation and merger between two independent companies. So also merger between two private limited companies should be viewed differently as compared to the merger of two public limited companies. The amended new Act should provide for less regulation in respect of mergers among associate companies/two private limited companies where no public interest is involved. The concept of contractual merger should also be thought of as an alternative to the form of merger available under the Act as on date.

## Cross Border Mergers

21. A forward looking law on mergers and amalgamations needs to also recognize that an Indian company ought to be permitted with a foreign company to merger. Both contract based mergers between an Indian company and a foreign company and court based mergers between such entities where the foreign company is the transferee, needs to be recognized in Indian Law. The Committee recognizes that this would require some pioneering work between various jurisdictions in which such mergers and acquisitions are being executed/created.

22. The Indian shareholders should be permitted to receive Indian Depository Receipts (IDR) in lieu of Indian shares especially in listed companies or foreign securities in lieu of Indian shares so that they become members of the foreign company or holders of security with a trading right in India (especially in listed companies). Further, in such cases, the shell of such company should be allowed to be dissolved without winding up with court intervention. The present Act does not permit this form of merger in view of the specific definition of company under section 390(a) of the Companies Act. The Committee noted that apart from amendments to the Companies Act, suitable changes may be necessary in the Income Tax Act, Foreign Exchange Management Act and provisions relating to IDR to enable merger of an Indian Company with foreign entity. The Committee therefore recommended adoption of international best practices and a coordinated approach while bringing amendments to the code of merger in the Companies Act.

**<u>Disclosure Requirements:</u>**

23. As the shareholders need to have complete information in the case of a scheme of merger/acquisition, specially in the case of promoter initiated mergers, the Act/Rules should list out the disclosure requirements in the explanatory statements to be sent to the shareholders in respect of the scheme filed before the Courts/Tribunals. In the case of Companies required to appoint independent directors, the Act should mandate the Committee of independent directors as a monitoring body to ensure adequacy of disclosures.

**<u>Other matters:</u>**

**<u>Corporate Debt Restructuring</u>**

24. The Reserve Bank of India has specific tools for fast track debt restructuring known as the CDR Mechanism (Corporate Debt Restructuring Mechanism). It is often seen that sometimes even though 75% of the secured creditors consent to the debt restructuring and make significant sacrifices, minority secured creditors or unsecured creditors put a spoke through the wheel. As a result, such schemes that would otherwise enable the return of the corporate to viable operation, get delayed or scuttled.

25. As in the case of contractual mergers or schemes of arrangement, the Committee recommends that if the petitioning creditors or petitioning company is prima facie able to prove that 75% of the secured creditors who have consented to the CDR Mechanism have made sacrifices to restructure the company then, notwithstanding the minority dissent, such a scheme should be sanctioned on filing.

26. Appropriate remedies for misstatement and the ability to revoke such an order with punishment for any misstatement would be an adequate safeguard for false misstatement. The unsecured creditors are subsequent in the queue and without the consent of the secured creditors and their debt restructuring, they would have no hope to receive their dues. However, to safeguard their interests and to ensure the

continuity of the company's functioning, the scheme must satisfy a minimum liquidity test and should have provisions for a security pool either made available by the secured creditor as cash availability or by the promoter to progress the scheme of restructuring.

27. Such schemes must contain safeguards against fraudulent preference and must have a creditors' responsibility statement, similar to a directors' responsibility statement, appended to it. Withdrawal from the security pool provided for by the liquidity test could be regulated by the Court/ National Company Law Tribunal.

28. The Committee recommended that the need to file a separate scheme for reduction of capital simultaneously the scheme for merger and acquisition should be avoided. The provisions relating to obtaining consent from unsecured creditors should be done away with. To ensure continuity of the existence of transferee company/resulting company, the Committee felt the need to mandate requirement of a satisfactory liquidity test and prescribed debt equity norms. The creditors consent may be necessary only in case of companies not meeting the liquidity test.

**Amalgamation in public interest**

29. Existing Section 396 empowers Central Government to order amalgamation of two or more companies in public interest. It has been suggested that these provisions should be reviewed. It is felt that amalgamation should be allowed only through a process overseen by the Courts/Tribunals. Therefore, instead of existing provisions of Section 396, provision should be made to empower Central Government to approach the Court/Tribunal for approval for amalgamation of two or more companies.

**Fees on Increased Authorized Share Capital**

30. At any point of time the transferor company and the transferee company, both companies would have paid fees of their respective authorized share capital at the rates specified in Schedule X of the Companies Act, 1956. Upon dissolution of the transferor company into the transferee company, the fees paid by the transferor company go waste and the transferee company gets no set off for the same.

31. In order to facilitate and encourage merger and acquisition activities, it is recommended that the fees paid by the transferor company on the authorized share capital should be available as a set off to the transferee company upon the sanction of the scheme of amalgamation by the High Court. This principle should apply both in respect of merger and demerger cases.

**Introduction of Non Obstante Clause in Section 394(2)**

32. Section 394(2) of the Companies Act, 1956 provides for vesting of assets and liabilities of the transferor company in the transferee company upon the sanction of

the scheme of amalgamation by the High Court. Since the section does not contain a non-obstante clause, it creates immense practical difficulties in actual transfer of the various properties/assets of the transferor company into the transferee company.

33. It was noted that the Sick Industrial Companies (Special Provisions) Act, 1985 and Section 32 thereof had clear provisions in the nature of a non-obstante declaratory order whilst sanctioning a scheme of restructuring. The Sick Industrial Companies Act has been subsumed in the company law and the principles therein, therefore, are eminently capable of being modified and applied in the new company law to be made.

34. It is therefore recommended that a non-obstante provision be introduced in the relevant provisions of the law to ensure that the assets and liabilities of the transferor company absolutely vest in the transferee company notwithstanding anything to the contrary in any other law for the time being in force. This would ensure that the transferee company is not subjected to cumbersome formalities for the transfer of assets and liabilities in its own name.

## Chapter XI : Investigation under the Companies Act

1. The Companies Act, 1956 provides for investigation of the affairs of companies under sections 235-250A of the Act. In addition, the Act provides for a separate process of inspection of Books of Accounts of companies under Section 209A. The Committee considered these provisions.

### Inspections

2. A view was taken that inspection of Books of Accounts, taken up in isolation, would not serve much purpose. Indeed, in the present form as provided for under S209 A of the Act, there is a danger that such inspections may be taken as a part of administrative routine. There would be a considerable expenditure of time and energy both on the part of the inspecting agency as well as the company without accomplishing much. Compliance with law cannot be enabled by a presumption of violation. Nor can it be ensured by physically checking of entities involved. If that were the case it would be practically impossible to enforce any legal system. The benefits of having an elaborate framework of statute and rules would be lost if law enforcing agencies are required to also physically inspect the subject entities to be confident that they are complying with it. Compliance should be based on enlightened self interest, requiring intrusion by law enforcement agencies only in limited, well established circumstances. It should not be the intention of the law to establish an "Inspector Raj"

3. The Committee was of the view that state intrusion into the affairs of a corporate entity should be regarded a sign of collapse of its governance structure. However, if and when such intrusion takes place, it should be well directed, effective and should have deterrent effect. More damage would be done by frequent intrusion into the affairs of companies with little or low application of sanctions. Such interaction between the state and the corporate citizen would result in an unhealthy relationship, imposing undesirable transaction costs. Nor, should law provide excessive powers to enforcement agencies to completely disrupt or paralyze the functioning of a corporate entity through arbitrary exercise of statutory powers on mere suspicion or an engineered or a frivolous complaint. The Committee are therefore of the view that instead of separate provisions for both inspection and investigation under the Act, a single comprehensive process of investigation, to be taken up in a manner mandated by law and protecting the rights of the companies, may be provided for. This would enable Government to focus in a better and more result-oriented manner for enquiry into the defaults by the Companies.

### Random Scrutiny

4. The Committee felt that overregulation and excessive supervision could disrupt the functioning and the decision making processes in a company. This would also tend to penalize actions taken in good faith by managements particularly of small companies who may not have access to expert professional advice. An atmosphere of

suspicion is unlikely to result in improvements in corporate governance. Companies would be wasting resources in evasive tactics which would impose unnecessary costs in a competitive environment. The Committee is of the view that rather than inspection of the working of companies through the enforcement machinery merely to assess whether a company is compliant with the law, the law should place the liability for compliance on the managements and owners/controlling interests of the companies, combined with a system of oversight through random scrutiny of the filings of documents by the companies. This exercise should not only enable up to date filings but should also identify gaps in disclosures by the companies. On the basis of such random scrutiny, the Registrar may also have the power to call for information, documents or records as required under law. If, from such random scrutiny, sufficient grounds arise warranting investigation of the affairs of the company, the same may be considered by the Central Government.

## Investigations

5. The Central Government may be empowered to appoint inspectors to investigate either on its own if it is of the opinion that such investigation is required in public interest, or on the request of the company on the basis of a special resolution, or on the direction of the court/Tribunal or from such members of the company having requisite number of shares as may be specified.

6. The Committee is of the view that investigation of the affairs of a company should be treated seriously. Once taken up, it should result in deterrent imposition of penalties. For the process of investigation to be effective, suitable powers should be provided to compel action by the company to enable proper investigation including production of relevant records. The existing Act provides for a framework to enable this. The Committee however recommends that this framework should be reviewed and made more effective. Powers to call for and inspect records of a company would be a part of this framework.

7. Any reported violation of a specific provision of the law should not become justification for an investigation. It should be possible for prosecution for such offences to take place after issuing a statutory notice. Before an investigation of the affairs of a company is taken up, there should be a reasonable opportunity available to the company to explain its conduct.

8. Complaints against the company should be by clearly identified complainant and should be required to be accompanied by a filing fee. Such complaints should invariably be referred to the company to ascertain the company point of view before any opinion is formed as to justification for investigation.

## Private professionals as Inspectors/Investigators

9. The Central Govt. may appoint any officer of Govt., any private professional or group/firm of professionals as inspector for investigation. It should however be ensured that there is no conflict of interest. The Inspector/Investigator or his partners should not have any material relationship with the corporate entity or its holding or subsidiary entities. The present provisions relating to powers of the inspector, duties of directors, officers or other persons during the course of investigation, punishment

for non-production of records and furnishing of false information and other related matters may be retained. The Act may provide for punishment for destroying or mutilating company's records by its director or officers. The provisions of investigation should also be extended to foreign companies which are carrying out business in India.

**Expenses of Investigations**

10. The expenses of investigation should be borne by the Central Government where such investigation has been ordered on its own. It should however be recovered from the applicant if the investigation has been ordered on the request of an applicant.

**Investigation of Serious Frauds**

11. The Committee took note of the fact that the Government have established the Serious Frauds Investigation Office (SFIO), a specialized, multi-disciplinary organization to deal with cases of corporate fraud. The Central Government may refer complex cases involving substantial public interest or multi-disciplinary ramifications to the officers of the SFIO. The Committee feel that setting up of such an organization is essential to unravel the complex corporate processes that may hide fraudulent behaviour. The SFIO should be strengthened further and its multi-disciplinary character retained.

12. In addition to investigation, there is also a need to take up prosecution of the concerned corporate and officers in default in the appropriate forum. For this purpose, procedures would need to be simplified to enable SFIO to move swiftly and purposefully for successful prosecution of the guilty. To enable this, there are certain ambiguities in the law which would have to be removed to enable SFIO to take up prosecution under the IPC in addition to violation of the Companies Act. The Committee recommends that a separate statute may be framed to regulate and guide the functioning of the (SFIO) and to address such issues to enable successful investigation and prosecution of cases of corporate fraud. Therefore, presence of SFIO may be recognized in the Companies Act. Officers of the SFIO may also be authorised by Central Government to file complaints for offences under Criminal Procedure Code in addition to for offences under the Companies Act.

13. The Committee took note of the fact that corporate frauds were generally the result of very complex and intricate series of actions. It may not be easy for the law enforcement agencies at the State Government level to respond effectively to such situations in the absence of proper training and development of skills of the concerned law enforcing personnel for such investigations. The Committee recommends that the SFIO, set up by the Central Government, should serve as a Nodal Agency for development of such expertise and its dissemination to the State Governments, who may also be encouraged to set up similar organisations and provide requisite specialization as a part of their action against economic offences. This would also enable better coordination in respect of prosecution of offences under IPC.

## Chapter XII : Offences and Penalties

1. The Companies Act, 1956 provides the legal basis for various corporate governance norms that are considered essential for proper corporate operation and protecting the rights of stakeholders. Violations of such norms are defined as offences with associated penalties. Essentially, law should be such that all subject entities should comply with it in their own interest. Nevertheless, it would not be realistic to expect that all companies would comply with the framework voluntarily. There would be some entities that would seek gains at the cost of legitimate rights of others, sometimes by fraudulent behaviour or through violation of the legal regime. However, law must also provide clear definition of what constitutes an offence and provide penalties that act as deterrent to companies from taking such action. Simultaneously, it should provide for procedures that enable application of penalties promptly and effectively.

2. The scheme provided under the law should encourage compliance through self regulation. The best enabling environment for compliance with law is the presence of an informed and vigilant group of stakeholders. Therefore, the law should clearly define the rights of stakeholders and the means of their redressal. The state should provide the wherewithal for quick redressal of the wrong committed and deterrent signals to others, clearly demonstrating consequences of non-compliance. The State shall have to discharge an important responsibility not only in framing of the law, appropriately recognizing stakeholder rights, but also in its effective implementation and administration.

3. There is also a need to provide for a regime of penalties commensurate with the offence. Actions violative of governance provisions in a manner that deprive the shareholders of their rights need to be treated seriously. The Committee are of the view that all fraudulent behaviour should be addressed through stringent penalties. Inadequate, wrong or fraudulent disclosures, or actions that do not allow shareholders democracy or a competitive market for corporate control to operate also need to be addressed through suitably deterrent provisions. Violations of a procedural nature that do not irretrievably damage stakeholders rights need to be treated differently.

4. At present, the process of prosecution for offences faces many delays. Under the present law, all lapses, howsoever trivial, are required to be tried by the Trial Court as criminal offences. Delays are also attributable to the procedural aspects required to be followed to bring the offender to book under Companies Act, 1956. Most violations are of procedural nature. However, there is no structure for dealing with such offences speedily. The delayed processing of complaints leads to enormous administrative burden and high cost to the economy. The process of prosecution gets prolonged and the deterrent effects of the penal provisions get diluted.

### Review of penalty levels

5. The Committee discussed at length the need for enhancing the penal provisions under the Company Law. It was felt that existing penalty structure did not provide suitable deterrence and needed to be reviewed and enhanced. During the course of its deliberations the Committee also received presentations made by Shri Shardul Shroff, who had separately been commissioned by the Ministry of Company Affairs to go into the penalty structures under the Companies Act 1956 and make recommendations for its revision. The Committee also noted the constitution of a Committee headed by Shri O.P. Vaish to consider ways and means to improve the process of prosecution under the Companies Act, 1956. This Committee is yet to submit its report. The Committee is of the view that the present framework of penalties does not have the desired deterrent effect and needs to be reviewed. The appropriateness of a penalty should also be seen in context of the damage, the violation of law causes to stakeholder rights and the deterrent impact required. The Committee also felt that the law should enable the flexibility of such a regime by grouping quantum of all penalties in a Schedule that may be revised from time to time.

## Offences by Companies

6. The Committee is of the view that in tune with legal developments in the country, guided by recent pronouncements of the Apex court it would be appropriate for the law to provide a regime of penalties for companies. These would be monetary in nature since it would not be feasible to imprison an artificial person such as a company. Such penalties should also be relatable to the size of the company in addition to the nature of the offence.

## Liability of the Board

7. In the system of Governance in the corporate entity, it is evident that the Board would play a crucial role. The liability of the Board would have to be clear and absolute for the actions of the company. However, a distinction has to be drawn in situations where there is collective liability of the Board or that of individual directors. Where an offence is so obvious and fundamental that the very participation in the decision making process is enough to establish culpability, collective responsibility may be thought of. In all other cases, focus has to be on individual liability of directors.

8. While examining the question of appointment of Independent directors, the Committee went into the question of attributability of knowledge or intention for wrong-doing before holding an Independent Director liable. The Committee is of the view that similar regime should apply to non-Whole Time Directors.

9. In the case of Whole Time Directors, the regime has to take into account their special position and access to the information and resources of the company. The responsibilities of such directors have to be correspondingly higher. Besides, they are in a better position to explain the conduct of the company. Therefore, while taking the process of investigation/prosecution of directors of the company, statutory notices should issue only to Whole Time Directors. Non-Whole Time Directors may be asked to explain on applying attributability or 'knowledge' test.

10. The law should also seek to discourage “shadow directors” who tend to operate from behind he scenes by adopting a framework of ‘attributability’ of directions to such persons, if the Board is accustomed to act on their instructions in any or all matters.

**Officers in Default**

11. At the same time a clear regime for identification of the officers in default is necessary. Elsewhere, we have suggested companies of certain types having CEOs/CFOs/Company Secretaries on a mandatory basis. The liability of such individuals as also other officers of the company in default has to be provided for. Equally important would be the role of qualified professional such as the accountant, the auditor, lawyer, company secretary providing corporate advice. Such individuals should be also be held liable for wrong doing if it can be established that they had not specifically advised against actions or behaviour violative of the law.

12. The Committee also recommends that in relation to criminal liability of officers in default, the rules should provide that :-

(i) directors should be liable where they authorize, actively participate in, knowingly permit, or knowingly fail to take active steps to prevent (including monitoring failures where appropriate) the default;

(ii) Managing Director/Whole Time Directors/CEO/CFO/Company Secretary should be liable on the same conditions, where Board has properly charged them with the relevant function;

(iii) Any person other than a Managing Director/Whole Time Director/CEO/CFO/Company Secretary (whether or not employed by the company) who, under the immediate authority of the Board/Managing Director/Whole Time Director/CEO/CFO/ Company Secretary, is charged with certain functions including maintenance, filing or distribution of accounts or records should also be liable where he authorizes, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, the default;

(iv) these definitions should be drafted so as to cover de facto directors, secretaries and managers;

(v) consideration will also need to be given on a case by case basis to the applicability of offences to receivers, administrators and liquidators.

In the case of (iii), the fact that someone further up the chain of command is liable would not relieve the delegatee of liability.

**Promptness in applying legal sanctions**

13. While the need for a review of the existing penalty levels was necessary to provide sufficient deterrent effect, it was felt that enhancing the penal provisions alone was not adequate to ensure compliance of the Law. It was felt that there was need for prompt administration of the legal sanctions on detection of an offence. For this, an in-house structure for dealing with cases of technical default involving imposition of

monetary penalties should be provided under the Company Law. It was noted that a vast majority of prosecutions filed related to such cases but due to delays involved resulted in delayed application of the legal sanction, thus reducing its impact. Such structure could be vested with powers to impose penalties for offences other than those punishable with imprisonment, or imprisonment and fine. Suitable officers of the Central Government could be designated to carry out this function on its behalf.

**Schedules to contain quantum of penalty**

14. In the present Act, penal provisions are generally contained in each section. The Committee supports the view that the company law should state clearly in relation to every rule what the consequences of violations/breach are to be. This may be possible by classifying the penalties in the form of schedules that may specify with relation to a given section, the general nature of offence, the mode of prosecution, punishment and daily default fine, where applicable.

**Categorization of Offences**

15. It is suggested that offences may be classified into two broad categories to be contained in different schedules (a) offences calling for imposition of monetary penalties only (b) offences calling for imposition of imprisonment with or without fine.

**Defaults of Technical Nature**

16. Defaults that are technical in nature may be addressed with a levy of late fee, the process of levying of which could be made non-discretionary. It was also suggested that the term `fine' could be substituted with word `penalty' to enable the proposed in house structure to deal with offences in question. To be in line with the criminal justice system in the Country, no order imposing penalty may be made unless the company has been given a reasonable opportunity of being heard.

**Filing of documents**

17. The Committee note with concern that a large number of companies are in default in respect of filing of documents. This in the envisaged scheme of things would result in vital disclosures being withheld from the public /stakeholders. The Committee feels that additional steps may be required to enhance compliance levels. Provision has to be made to book repeat offenders as well as those who are not deterred by late fees. The law should provide special powers to compel filing of documents. The Registrar of Companies should be enabled to make special orders in this regard. Non-compliance with this order should be enforced when prosecuting for related regulatory offences of default in filing obligations. Failure to comply with an order made in exercise of such powers by the Registrar should result in stringent enhanced punishment for the company and its directors. This power should be seem as being in addition to any action to enforce specific compliance by the order of the Civil Court.

18. The Committee also recommends coordination of effort between MCA, SEBI, Income-Tax and Banking authorities to ensure that financial information and particulars quoted by companies is on the basis of statutory filings only.

**Disclosures of offences by companies**

19. There should also be a provision for publication of the information relating to convictions for criminal breaches of Companies Act on the part of the company or its officers or key employees in the annual report of the company. This obligation should extend to criminal convictions in respect of Companies Act only. Besides such disclosures may be required to be disclosed for the year in which they occurred and need not be repeated in subsequent annual reports.

**Specifying penalties**

20. The Companies Act may lay down the maximum as well as minimum quantum of penalty for a particular offence. However, the Act should also provide that while levying a particular quantum of penalty, the levying authority shall also take into consideration the size of company, nature of business, injury to public interest, nature & gravity of default, repetition of default etc.

**Penalties for fraudulent conduct**

21. At present the current Companies Act provides for a regime for addressing liability for fraudulent conduct of business by company u/s 542 read with section 406 for a working company. We are of the view that this provision would provide a valuable basis for dealing with fraudulent behavior on the part of companies and their management. We recommend that these sections should be used for enabling disgorgement of gains/diverted funds, if any, through fraudulent activity by the companies and their managements. We also recommend that penalties for offences committed with the intent of committing fraud should be enhanced to provide for suitable deterrent effect.

22. We also recommend that the provisions of these sections should also be applied to companies incorporated overseas but doing business in India to remove incentive for fraudulent activity by registering companies abroad to avoid criminal sanctions.

**Procedures, Jurisdiction and Appeal for Levy of Penalty :**

23. Under the proposed “in-house” procedure, the power to impose penalty (in the form of fine) may be vested with the Registrar of Companies who is a statutory authority. Since the minimum and maximum quantum of fine would be defined in the Act, this would restrict the scope for discretionary exercise of power. However, it would be necessary to provide for a mechanism for appeals against the orders of such authorities. Such appellate authority may also be specified in the Act. It is understood that the Government is contemplating setting up of an institutional structure to adjudicate on Company Law issues with the constitution of NCLT/NCLAT. Till the setting up of the NCLT, this would be subject to the jurisdiction of the High Courts. Appeal to Supreme Court against the order of NCLAT will lie only on substantial question of law.

24. It is understood that under the Companies (Second Amendment) Act, 2002 constitution of NCLT is envisaged to address matters relating to company law. The Committee further understands that this Forum would be headed by a person with

judicial qualifications not less than that of a High Court Judge. Its jurisdiction would extend to civil remedies to company law issues referred to it. However, in order to enable speedy imposition of penalties in respect of criminal offences, the possibility of vesting certain specified benches of the NCLT with criminal jurisdiction should also be examined. Such benches may comprise of members having judicial background only. The process would be subject to appeal to the NCLAT (Appellate Body) which is in any case envisaged to be headed by a person who has been Chief Justice of a High Court or a Justice of Supreme Court.

**Limitation Period for Commencement of Penalty Proceedings**

25. The Act should contain a limitation period in respect of commencement of penalty proceedings by the Government, completion of proceedings, time for appeal and the related matters. Since the Government would exercise quasi-judicial powers, sufficient judicial training should be given to the Officers of the Central Government to deal with the penalty proceedings.

**Recovery of Penalty Amounts**

26. Central Government should have the powers to recover the penalty amounts as arrears of land revenue by attachment and sale of moveable/immovable property of the person in default or by appointing a Receiver for the management of the properties of the person in default. The authority imposing penalty may also impose interest/additional penalty for delayed payment of the penalty. The Appellate authorities may be given powers to award costs with a view to discouraging filing of frivolous appeals.

**Revision of Orders Prejudice to Public Interest**

27. Specific authority may call for and examine the record of any proceedings under the Act, and if any order passed therein by the authority below is considered prejudicial to public interest, may pass such order thereon as the circumstances may justify, including an order enhancing or modifying penalty or directing a fresh levy of penalty.

28. No order should be made under this provision after the expiry of two years from the end of the financial year in which the order sought to be revised was passed.

**Rectification of Mistakes**

29. Suitable provisions should be made in law to enable rectification of mistakes in orders, refund of amounts becoming due on appeals or revisions, etc.

**Power of Compounding**

30. Any compoundable offence under the Act may, either before or after the institution or proceedings, be compounded at any stage of the proceedings. The Act may suitably prescribe the scale of compounding fees and the authority empowered to compound.

**Prosecution**

31. Any person committing an offence referred to in the Second schedule i.e. offences punishable with imprisonment or with imprisonment along with penalty may be proceeded against in the criminal Court but only with the previous approval of the Central Government or any other authority specified by the Central Government. No prosecution should be launched unless the offender is provided with a reasonable opportunity of being heard in the matter.

32. A suitable mechanism should exist in the amended Act for transfer of proceedings pending in the Court to the proposed in house structure of dealing with the first schedule offences.

**Phoenix Companies**

33. The Committee also deliberated upon the problem arising from the directors/management of a company acting in a manner that is deliberately detrimental to the company and then resuming operations again under a separate name or guise. It is understood that this phenomenon has been noticed in other economies also where it is termed as the "phoenix problem". This problem results from continuance of the activities of a failed company by those responsible for the failure, using the vehicle of a new company. The new company, often trading under the same or a similar name, uses the old company's assets, often acquired at undervalue and exploits its goodwill and business opportunities. Meanwhile the creditors of the old company are left to prove their debts against a valueless cell and the management to conceal their previous failure from the public. However, it is to be recognized that not all legitimate businesses succeed at the first attempt and there may be occasions where honest individuals may, through misfortune or lack of expertise find that they cannot make the business run successfully. In such cases, it would be appropriate for them to seek rehabilitation or place their company in liquidation on voluntary basis. The Committee feels that this issue should be addressed through a combination of disclosures, insolvency processes and disqualifications of delinquent directors.

**Lifting the Corporate veil**

34. In certain situation, despite the provisions of the company law providing for constitution of the Board and placing the liability on the board and officers in default, it may be possible for the promoters of controlling interests to circumvent the spirit of the law while observing its letter. Where fraudulent activity has been established through investigation the law should provide for lifting the corporate veil to provide access to such promoters or shareholders and to establish whether fraudulent action took place with their knowledge or at their instance. A framework of penalties should be provided in respect of such entities also.

**Protection to Whistle Blowers**

35. Law should recognize the "Whistle Blower Concept" by enabling protection to individuals who expose offences by companies, particularly those involving fraud. Such protection should extend to normal terms and conditions of service and from

harassment. Further, if such employees are themselves implicated, their cooperation should lead to mitigation of penalties to which they may otherwise be liable.

## <u>Chapter XIII</u> : <u>Restructuring and Liquidation</u>

1. Businesses need efficient and speedy procedures for exit as much as for start-up. World over, insolvency procedures help entrepreneurs close down unviable businesses and start up new ones. This ensures that the human and economic resources of a country are continuously rechannelised to efficient use thereby increasing the overall productivity of the economy.

2. However, as businesses grow in size there is also a danger that poor management, bad business judgement or plain fraud may result in a business becoming unviable. In such cases it is possible for the productivity of the enterprise to be restored at a low cost and without attendant trauma for the stakeholders by providing more capable managerial talent an opportunity to run it. In fact recent times have shown possibility of growth by entrepreneurs, some of them Indian, who have become dominant business entities internationally by achieving turnaround of sick firms and revitalization of dormant capacities.

3. The Indian system provides neither an opportunity for speedy and effective rehabilitation nor for an efficient exit. The process for rehabilitation, regulated by the Sick Industrial Companies (Special Provisions) Act 1985 through the institutional structure of BIFR is amenable to delays and does not provide a balanced or effective framework for all stakeholders. The process of liquidation and winding up is costly, inordinately lengthy and results in almost complete erosion of asset value.

4. The Committee noted that a beginning towards reform was made with the enactment of Companies (Second Amendment) Act, 2002, which in addition to significant changes in the restructuring and liquidation provisions provided for the setting up of a new institutional structure in the form of the National Company Law Tribunal (NCLT)/Tribunal and its Appellate Body, the National Company Law Appellate Tribunal (NCLAT). However, the process is not complete and a lot yet needs to be done. The constitution of the Tribunal is facing legal challenge and many parts of the enactment have not yet been notified.

5. Globally, reform in insolvency processes is recognized as an important means of improving competitiveness of any economy. It is particularly so in Indian context. Under the supervision of the United Nations Commission on International Trade Law (UNCITRAL), a Legislative Guide on Insolvency Law and Model Law on Cross Border Insolvency have been formulated and circulated to all countries. Similar initiatives have been taken up by other multilateral institutions. The Committee has had the benefit of consideration of such initiatives. Occasionally, a doubt is expressed as to whether developing countries should consider incorporation of such legal frameworks. The Committee feel that the Indian economy is now at a stage where articulation of a comprehensive framework that addresses insolvency issues would make a material difference to the productivity of the economy. The Committee is of the view that a review of the system for addressing corporate insolvency in the Indian context is urgently called for and recommends the following to the policy planners in India.

## Insolvency Law

6.1 An effective insolvency system is an important element of financial system stability. It is, therefore, essential to provide for a sound framework for restructuring and rehabilitation of companies along with a framework for winding up and liquidation. The framework should seek to preserve estate and maximize the value of assets; recognize inter se rights of creditors and provide equal treatment of similar creditors while dealing with small creditors equitably. It should enable a timely and efficient resolution of insolvency and establish a framework for cross border insolvency. The present framework does not provide a balanced resolution of various stakeholder issues, is time consuming and inefficient.

6.2 Corporate insolvency should be addressed in the Company Law. There is no need of a separate Insolvency Law for the present.

## Liquidation and Rehabilitation

7.1 The Insolvency law should strike a balance between rehabilitation and liquidation. It should provide an opportunity for genuine effort to explore restructuring/ rehabilitation of potentially viable businesses with consensus of stake holders reasonably arrived at. Where revival / rehabilitation is demonstrated as not being feasible, winding up should be resorted to.

7.2 Where circumstances justify, the process should allow for easy conversion of proceedings from one procedure to another. This will provide opportunity to businesses in liquidation to turnaround wherever possible. Similarly, conversion to liquidation might be appropriate even after a rehabilitation plan has been approved if such a plan was procured by fraud or the plan can no longer be implemented.

7.3 The Committee noted that a recent survey by World Bank (Doing business in 2005 – India Regional Profile) has pointed out that it took 10 years on an average to wind up / liquidate a company in India as compared to 1 to 6 years in other countries. Such lengthy time-frames are detrimental to the interest of all stakeholders. The process should be time-bound, aimed at maximizing the chances of preserving value for the stakeholders as well as the economy as a whole.

7.4 The Insolvency process should be overseen by a neutral forum in a non-intrusive manner. Such a single, independent Statutory forum, should have the capacity and expertise to deal with the specialized commercial and technical characteristics of the Insolvency Law and the process; make an assessment and decide the course of action (rehabilitation or liquidation) that may need to be adopted at the earliest possible stage while balancing the interests of all stakeholders equitably. The Committee noted that the Companies (Second Amendment) Act, 2002 had brought about significant changes in the provisions dealing with rehabilitation/winding up / liquidation of companies in the present Act and had also proposed that an institutional structure for the purpose be set up in the form of NCLT/NCLAT. This Institutional Structure, which would provide the desirable single independent forum is yet to be constituted. The Committee hope that this is done speedily and are of the view that its establishment would provide a major initiative for the reform of the insolvency system in the country.

**Focus on Rehabilitation**

8. Law should provide a reasonable opportunity for rehabilitation of a business before a decision is taken to liquidate it so that it can be restored to productivity and become competitive. However this opportunity should incentivize genuine effort. Special care should be taken to ensure that this is not misused by any stakeholder to delay proceedings, strip asset value or otherwise work to the detriment of the business and other stakeholders.

**Time bound proceedings**

9.1 A definite and predictable time frame should be provided for attempt at rehabilitation and for the liquidation process. The existing time frame in India is too long and keeps precious assets locked in proceedings for many years, destroying their value in the process.

9.2 A period of one year should be adequate for rehabilitation process from commencement of the process till sanction of a plan. There should also be a definite time period within which proceedings may commence from the date of filing of the application for rehabilitation.

9.3 The process should limit the possibility of appeals at every stage so that the process is not delayed through frivolous appeals or stalling tactics.

9.4 On an average a time frame of two years should be feasible for the liquidation process to be completed.

9.5 A fixed time period should be provided for each stage of rehabilitation and liquidation process. Extension at every stage should be rare and allowed only in exceptional circumstances and in any case without effecting the outer time limit provided for the process.

**Applicability and Accessibility**

10.1 The Insolvency process should apply to all enterprises or corporate entities including small and medium enterprises except banks, financial institutions and insurance companies.

10.2 The concept of sick industrial company should be replaced by insolvent company or enterprise to bring it in harmony with the principles of the proposed Insolvency Law.

10.3 Both Debtors and Creditors should have fair access to the insolvency system upon showing proof of default.

10.4 Rather than erosion of net worth principle, test should prescribe default in payment of matured debt on demand (liquidity test) within a prescribed period. The balance sheet test tends to be more costly as it generally requires an expert evaluation to review books, records and financial data to determine the enterprise's fair market value. While facilitating the invocation of process at an early stage, this would discourage manipulation of accounts to create erosion in net-worth. The opportunity of restructuring should be available before the asset is rendered non-performing.

10.5 Debtors seeking recourse to rehabilitation should be allowed to approach the Tribunal only with a draft scheme for rehabilitation for the consideration of Tribunal. This would bring forward genuine efforts of rehabilitation and provide an opportunity for assessing the viability of the business at the earliest to decide the appropriate course of action to be adopted.

10.6 Creditors being at least 3/4th in value should also be liable to file a scheme for rehabilitation.

10.7 If creditors approach for winding up, opportunity should be given to debtor to file a scheme if such an opportunity is sought. The process should enable consultation of scheme with the creditors and converting the liquidation proceedings into restructuring proceedings, if the Tribunal is of the opinion that there are fair chances that the company may revive.

10.8 The law should require the provision of relevant information about the Debtor to be made available for effective consideration of the scheme. The law should enable obtaining by the Tribunal, independent comment and analysis of that information by experts.

**Duties and prohibitions on admission**

11.1 On admission of application for rehabilitation, the law should impose certain duties and prohibitions to apply to debtors and creditors for an effective resolution of Insolvency and balancing the stakeholders' interests in the process.

11.2 There should be an automatic prohibition on Debtors' rights to undertake transfer, sale or disposition of assets or parts of the business. Permission may be granted only to the extent necessary to operate the business, with the approval of the Tribunal. This would protect the assets, build confidence of secured creditors and encourage them to participate in the insolvency process.

**Summary Dismissal of proceedings**

12. The law should vest with the Tribunal the power to summarily dismiss the proceedings for not meeting commencement standards with cost / sanction. Once rejected no further reference should be maintainable. Filing of repeated references by debtor in spite of earlier rejection has led to abuse of the process.

**Moratorium and suspension of proceedings**

13.1 A limited standstill period is essential to provide an opportunity to genuine business to explore re-structuring.

13.2 The law should, therefore, impose a prohibition on the unauthorized disposition of the Debtors' assets and suspension of actions by Creditors to enforce their rights or remedies against the Debtor on the assets for a limited prescribed period to preserve and protect assets besides maximizing its value. This will facilitate unobstructed conduct of Insolvency process by the Tribunal without having to deal with complexities of multiple creditor actions in Debt Recovery Tribunals. This will also encourage creditors to participate in the Insolvency process besides achieving fair and orderly administration and upholding fundamental objectives and policy of the Insolvency Law.

13.3 Rather than being automatic, the prohibitions should be on Tribunal's order on a specific application with approval of majority creditors in value. The Tribunal should have adequate power to lift or modify the prohibition in case the circumstances so warrant.

13.4 The law should provide for treatment of unperformed contracts. Where the contracts provide for automatic termination on filing of insolvency, its enforcement should be stayed on commencement of insolvency.

13.5 There should be enabling provisions to interfere with the contractual obligations which are not fulfilled completely. Such interference or overriding powers would assist in achieving the objectives of the insolvency process. The power is necessary to facilitate taking appropriate business and other decisions including those directed at containing rise in liabilities and enhancing value of assets.

13.6 Exceptions of such powers are also essential to be insured in the law where there is a compelling, commercial, public or social interest in upholding the contractual rights of the counter party to the contract.

**Governance/Management (Rehabilitation proceedings)**

14.1 In regard to the potentially insolvent companies, it is essential that self-regulatory measures be required to be taken by a company to protect the interests of various stakeholders, preserve assets and adopt such other measures as may be necessary to contain insolvency. This would enable Whistle Blowing on impending insolvency. The Committee is of the view that a meeting of the secured creditors should be convened by the debtor to consider a rehabilitation plan when the Company has failed to repay its due debt without waiting for creditors to act on default or filing of application for rehabilitation. There should be a provision that when accumulated losses in any financial year are equal to 25% or more of its average net worth during last two financial years and there is a default in making payments to the creditors, the companies should convene a General Meeting of shareholders without any delay to consider such a situation.

14.2 There should also be a greater role and responsibility for parties most affected by the insolvency once the proceedings aimed at addressing it are initiated. The key stakeholders should be incentivized to actively participate in the process. They should be consulted in the decision making.

14.3 While the law should permit use and disposal of assets in ordinary course of business, capacity for management of the affairs of the business by debtors should be put to test in consultation with secured creditors. Otherwise creditors should be provided rights of substitution of debtors. Assets should in either case be subjected to supervision or management by impartial, independent, effective and capable

Administrator. This would enhance the confidence of the secured creditors in the process while preserving and protecting the assets.

14.4 Where circumstance justify such as failure to protect assets or deal with them in prejudicial manner, in the opinion of the Tribunal or majority creditors, full control of assets may be allowed to pass to administrator nominated by creditors through exercise of right of substitution.

14.5 In furtherance of achieving a fair, independent and balanced resolution of stakeholders interest, the role of Operating Agency envisaged under the existing law should be performed by on independent Administrator or such other qualified professional as may be prescribed. Currently banks and financial institutions are appointed as Operating Agency. Engagement of experts will also enhance the efficiency of process. The banks and financial institutions should participate in the operation through committee of creditors.

**<u>Governance/Management in liquidation</u>**

15.1 The management of the going concern should be replaced by a qualified Administrator appointed by the Tribunal in consultation with the secured creditors with board authority to administer the estate in the interest of all stake holders. An independent Administrator would be able to provide the best treatment to the assets and preserve its value and take other necessary decisions in the best interest of the business.

15.2 The law should provide for Administrator to be able to prepare and file a scheme for turnaround of the company, if the business is viable in which case the creditors and ex-management should have an opportunity to comment on the scheme.

15.3 The Administrator should have the same obligation as the management to secured creditors with right of information and supervision.

**<u>Governance : Secured Creditors and Creditors Committee</u>**

16.1 Secured creditors interests should be safeguarded by establishing a Committee of secured creditors. The Committee should enable creditors to actively participate in the insolvency process, monitor the process, and serve as a conduit for processing and distributing relevant information to other creditors and organizing creditors to decide on critical issues. This would provide a platform to all kinds of secured creditors to discuss the divergent views and build consensus and agreement on the issues that arise for consideration and decision. The process would also assist in expediting the insolvency process.

16.2 Law should provide for major decisions by general creditors assembly. There should be rules for appointment of members in the Creditors Committee and to determine the Committee's membership, quorum and voting rules, powers and conduct meetings.

16.3 The Law should enable appointment of professional experts and specialists by Creditor Committee to advise them on various technical and legal issues.

16.4 Directors of a debtor corporation should be required to attend meetings of Creditors Committee so that the decisions can be made on a well informed basis.

**Governance : Unsecured Creditors**

17.1 Unsecured creditors have no representation in the restructuring process. Lack of information leads to suspense and anxiety on their part resulting in multiple legal and other proceedings. This impacts the overall efficiency of the rehabilitation process.

17.2 A separate Committee to represent other categories of creditors and unsecured creditors and stakeholders could be formed with limited right to represent and hearing without right to vote on the plan and other decisions. Separate and independent rules for appointment of the creditors (other than secured) committee may be made with details of procedures for membership, quorum and voting rules, powers etc.

17.3 Enabling provisions would be required to coordinate meetings of unsecured and secured creditors to take decisions to move claims.

17.4 The law should provide for mechanism to recognize and record claims of unsecured creditors in preparation of the rehabilitation plan.

**Administration of Insolvency : Administrator and Liquidator**

18.1 A panel of Administrators and Liquidators should be prepared and maintained by an independent body out of professionals with appropriate experience and knowledge of insolvency practice. The panel should be of individual advocates, accountants, company secretaries, costs and works accountants and other experts rather than the firms so that the independence and accountability of individuals may be determined. The panel should be prepared in a fair and transparent manner. This would also ensure that appropriate professionals who are appointed on the strength of their knowledge and experience provide the service rather than the other partners or colleagues in their firms. The law should however provide power to the Tribunal to make exceptions to the rule and appoint firms.

18.2 The Tribunal should have powers to appoint Administrator and Liquidators out of the panel maintained by the independent body and Official Liquidators from panel of officials made available by the Government.

**Identification, Collection, Preservation, Disposition of Debtor assets and Property**

19.1 Law should provide a framework that incentivizes maximization of estate value.

19.2 The law should identify the assets that constitute the insolvency estate including assets of debtor (including those subject to security interest) and third party owned assets (such as leased and hypothecated assets) wherever located and provide for collection of assets forming part of insolvency estate by Administrator/ Liquidator. In the cases of rehabilitation, leased assets should form part of insolvency estate.

19.3 The law should provide for avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions, completed when the enterprise was insolvent or that resulted in its insolvency.

19.4 The suspect period prior to insolvency, during which the payments are presumed to be preferential and may be set aside, should be short to avoid disrupting normal commercial and credit relations. The period may be longer in case of gifts and related party transactions. Appropriate disclosure norms should be developed for this purpose.

19.5 The law should prescribe a flexible but transparent system for disposal of assets efficiently and at maximum values including sale by private treaty.

19.6 Where necessary, the law may allow for sales free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from assets disposal.

19.7 The sale of assets should be carried out by the Administrator/ Liquidator under the supervision of court.

**Valuation of debtor estate**

20.1 The Tribunal should appoint accountancy experts / professionals to ensure that true and fair picture of accounts of the debtor enterprise and financial assets is available.

20.2 Independent experts may be appointed as valuers for valuation of assets of a business concern under liquidation.

20.3 Debtors and Creditors should have the power to scrutinize and challenge the value before final order of fixing value.

20.4 There should be powers for annulment in appropriate cases with recovery/disgorgement.

**Claims Resolution : Treatment of Stake holders Rights and priorities on liquidation**

21.1 The law should provide for prompt and interim distribution of claims to creditors in line with priorities determined by law.

21.2 Rights and priorities of creditors established prior to insolvency under commercial laws should be upheld to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationship.

21.3 The status of secured creditors should be *pari passu* with employees in respect of their claims after payment of claims related to costs and expenses of administration of liquidation. Remaining proceeds should be distributed, *pari passu* with other creditors, unless there are compelling reasons to justify giving preferential status to a particular debt.

21.4 The number of priority classes should be kept to minimum so that rights and expectations of classes created prior to insolvency are not diluted.

21.5 Public interests, Government claims should not get precedence over private rights in the Insolvency process. Assets are created in the enterprise by the secured creditors who have a prior right over the proceeds when assets are liquidated. The dues of others arise due to the activity these assets create and should be collected when the business is running.

**Plans : Formulation, Consideration, Voting and Approval**

22.1 The law should not prescribe nature of plan except in terms of fundamental requirements and to prevent commercial abuse. This will provide the desired flexibility in preparation of the plan. The Tribunal should have the power to obtain independent comments on the plan.

22.2 Revival/rehabilitation plan should be approved by majority of secured creditors (75%) to bind all creditors. This would ensure that a small creditor is not able to stall the entire process even though the majority of the creditors are in favour of the plan.

22.3 In case no plan is approved, the business concern should automatically be liquidated.

22.4 There should also be enabling provisions to establish a mechanism for filing a negotiated plan for approval by Tribunal by the same majority class of creditors along with disclosure statements etc. and with supporting evidence of approval by majority.

**Scheme/Plan : Binding Effect, Implementation and Amendment, Discharge and Conclusion**

23.1 There should be provision for monitoring and effective implementation of the scheme/ plan.

23.2 Provision should also be made to amend the plan in the interest of rehabilitation if an amendment becomes necessary due to change in circumstances and developments that effect the successful implementation of the plan.

23.3 There should be a provision in law for termination of the plan and to liquidate the company.

23.4 The law should provide for a discharge or alternation of debts and claims that have been discharged or otherwise altered under the plan. Where approval of the plan has been procured by fraud, the plan should be subject to challenge, reconsidered or set aside.

23.5 Reorganization proceedings should conclude when plan is fully implemented or at an earlier date to be determined by the Tribunal.

23.6 Liquidation proceedings should conclude following final distribution or determination that no distribution can be made.

**The Tribunal (National Company Law Tribunal)(NCLT)**

24.1 As per Companies (Second Amendment) Act, 2002, the National Company Law Tribunal (NCLT) is envisaged as the forum to address Insolvency issues. It is hoped that this forum is constituted speedily. The Committee however takes this opportunity to focus on some important aspects widely considered important for proper functioning of such a body.

24.2 The Insolvency Tribunal should have a general, non-intrusive and supervisory role in the rehabilitation and liquidation process. Greater intervention of the Tribunal is required only to resolve disputes by adopting a fast track approach. The Tribunal should adopt a commercial approach to dispute resolution observing the established legal principles of fairness in the process.

24.3 The Tribunal should set standards of high quality and be able to meet requisite level of public expectations of fairness, impartiality, transparency and accountability. Selection of President and Members of the Tribunal should be such so as to enable a wide mix of expertise for conduct of its work.

24.4 The Tribunal will require specialized expertise to address the issues referred to it. The law should prescribe an adequate qualification criterion for appointment to the Tribunal as well as training and continuing education for judges/members.

24.5 Rules should be made in such way that ensure ready access to court records, court hearings, debtors and financial data and other public information.

24.6 Standards to measure the competence, performance and services of the Tribunal should be framed and adopted so that proper evaluation is done and further improvements can be suggested.

24.7 The Tribunal should have clear authority and effective methods of enforcing its judgments. It should have adequate powers to deal with illegal activity or abusive conduct.

**Insolvency Practitioners**

25. Currently, the law does not support effective participation of professionals and experts in the Insolvency process. There is no shortage of quality professionals in India. Disciplines of chartered accountancy, company secretaryship, cost and works accountancy, law etc can act as feeder streams, providing high quality professionals for this new activity. In fact, private professionals can play a meaningful role in all aspects of process. Insolvency practice can also open up a new field of activity for service professionals while improving the quality of intervention at all levels during rehabilitation/winding up/liquidation proceedings. Law should encourage and recognize the concept of Insolvency Practitioners (Administrators, Liquidators, Turnaround Specialists, Valuers etc). Greater responsibility and authority should be given to Insolvency Practitioners under the supervision of the Tribunal to maximize resource use and application of skills.

## Regulation, Supervision and Costs

26. The law should create the mechanism for debtor to meet the cost of rehabilitation and liquidation. In liquidation process, the law should facilitate quick disposal of assets to meet the balance cost of the insolvency. Efforts should be made to generate funds to meet the cost of restructuring by disposal of surplus assets, if any of the company. A view was expressed by the representatives of some banks/financial institutions that creditors should not be required to supplement the expense of rehabilitation / liquidation. The Committee examined this view and felt that businesses that were viable and could be rehabilitated should be provided a fair opportunity for the purpose. This may require all stakeholders including creditors to make sacrifices. In the interest of avoiding business failure and consequent distress, wherever possible, this would be well worth the effort. Besides, under the proposed framework, rehabilitation effort would be taken up in consultation with creditors in a manner that is not open ended. Internationally, banks have actively participated and have facilitated business rehabilitation. It was time that a comprehensive and a balanced approach was adopted in India as well. The banks/financial institutions should, therefore, approach the new framework, which was consistent with international practices in a positive manner and participate meaningfully in such exercises.

## The Insolvency Fund

27.1 The Committee noted that consequent to the Companies (Second Amendment) Act, 2002, a provision has been made for levy of rehabilitation cess by the Government, to be charged on the basis of turnover of a company. All companies would be subject to such cess which would be utilized for rehabilitation of sick companies. The Committee was of the view that such a modality resulted in efficient firms being penalized to the benefit of inefficient ones and as such was undesirable. Besides, the structure resulted on a tax on turnover rather than on income which tended to dis-incentivize growth. The Committee, therefore, recommended repeal of this provision.

27.2 The Committee, however, took into account the concerns associated with protection of vulnerable stakeholders who suffer the most during insolvency. Besides, the cost of the insolvency process would also have to be met. Therefore, the Committee took the view that an Insolvency Fund may be set up to meet the costs of the insolvency process. Companies may contribute to the Fund on their own option. The corpus of the Fund may also be enhanced by grants from the Government. Government should consider providing incentives, including tax incentives to encourage contributions by companies to such a Fund.

27.3 Contributions by companies to such a Fund should entitle them to certain drawing rights in the event of an insolvency. A company under restructuring and liquidation should be able to draw out of the Fund only in proportion of the contribution made by it to the Fund in the pre-restructuring and pre-liquidation period. This would enable high risk companies to decide on the optimum contribution to be made to the fund.

27.4 The application of the Fund to the insolvency/rehabilitation process should be subject to the orders of the Tribunal. The Tribunal may, in suitable circumstances allow an over draft from the Fund in the rehabilitation process, in which case the overdraft amount should be shown against the credit of the company and provision of its repayment should be made in the rehabilitation scheme.

27.5 Insolvency Fund should be credited to a separate account and not to the Consolidated Fund of India. The Fund should be managed by an independent Administrator appointed by the Government.

**International considerations**

28.1 Insolvency laws should provide for rules of jurisdiction, recognition of foreign judgments, co-operation and assistance among courts in different countries and choice of Law. Many countries have already adopted the UNCITRAL Model Law on Cross Border Insolvency with or without modifications. Adoption of the Model Law by India may also be considered with suitable modifications keeping pace with its adoption by countries having significant trade / investment linkages with India.

28.2 The law should contain enabling provisions to deal with issues concerning treaties and arrangements entered into with different countries by India, present and future. India has developed commercial relationship with new countries in recent years and there would more new business relationships in future leading to treaties and arrangements from time to time. The law should facilitate recognition of jurisdiction, courts, judgments, cooperation and assistance from these countries.

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